ESTATE TAX ISSUES—1982

HEARING

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1983 and S. 2479

MAY 27, 1982

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ESTATE TAX ISSUES—1982

THURSDAY, MAY 27, 1982

U.S. SENATE,
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:06 p.m., in room 2221, Dirksen Office Building, Hon. Steven D. Symms (chairman) presiding.

Present: Senator Symms.

[The press release announcing the hearing, the text of bills S. 1983 and S. 2479, background material relating to S. 2479, S. 1983, and the opening statement of Senator Dole follow:]

[Press Release No. 82-135]

FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION SETS HEARING ON ESTATE TAX ISSUES

Senator Steve Symms, Chairman of the Subcommittee on Estate and Gift Taxation of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing to discuss estate tax issues on Thursday, May 27, 1982.

The hearing will begin at 2 p.m. in room 2221 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Symms indicated that the following proposals would be discussed:

(1) S. 2479, introduced by Senator Symms with Senators Bentsen, Boren, and others. The bill would revise section 6166 of the Internal Revenue Code with respect to the availability of the installment method of paying estate taxes. In particular, the bill would deal with the following areas:

Providing a judicial forum for resolving qualification and acceleration disputes under section 6166;

The treatment of indirect, as opposed to direct, interests in a trade or business;

The treatment of indebtedness as an interest in a closely-held business;

The treatment of oil and gas proprietorships as interests in a trade or business for purposes of section 6166;

The treatment of interests held by independent professionals in mineral properties obtained in return for services in locating, identifying, or acquiring such properties;

Eliminating the distinction between partnership capital and an interest in partnership profits for purposes of qualifying for section 6166;

Improving the coordination of section 6166 with Subchapter S;

Simplifying attribution rules under section 6166;

Increasing the availability of aggregation of interests to qualify under section 6166;

Providing additional exceptions from the acceleration provisions of section 6166, including expansion of the exception for section 303 redemptions;

Changing the treatment of interest attributable to a section 6166 deferral as an administration expense.

(2) S. 1983, introduced by Senator Symms and Senator Wallop. The bill would provide a transition rule for purposes of estate and gift taxation for disclaimers of property interests created by transfers before November 15, 1958.

(3) In addition, the Subcommittee will receive testimony on proposals to codify current administrative practice with respect to the valuation of mineral properties for estate tax purposes.

97TH CONGRESS
1ST SESSION

S. 1983

To amend the Internal Revenue Code of 1954 to provide transitional rules for estate and gift tax treatment of disclaimers of property interests created by transfers before November 15, 1958.

IN THE SENATE OF THE UNITED STATES

DECEMBER 16 (legislative day, NOVEMBER 30), 1981

Mr. SYMMS (for himself and Mr. WALLOP) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide transitional rules for estate and gift tax treatment of disclaimers of property interests created by transfers before November 15, 1958.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (c) of section 2518 of the Internal Revenue Code of 1954 is amended by adding the following new paragraph:

"(3) PRIOR TRANSFERS.—A disclaimer of an interest created by a transfer of property made before

November 15, 1958, shall constitute a 'qualified disclaimer' for purposes of this subtitle if—

"(A) such disclaimer satisfies the requirements of subsection (b) without regard to paragraph (2) thereof, and

"(B) such disclaimer is made—

"(i) at any time prior to 9 months following enactment of this paragraph, or

"(ii) within 9 months of the first day the disclaimant had knowledge of such interest, provided the first day the disclaimant had knowledge of the interest is established by clear and convincing evidence (but in no event shall this clause apply to a disclaimer made after December 31, 1991)."

(b) Paragraph (2) of section 2009(e) of the Tax Reform Act of 1976 is amended by striking out "after December 31, 1976." and inserting in lieu thereof "before November 15, 1958, or after December 31, 1976.".

(c) The amendments made by subsections (a) and (b) shall apply to disclaimers made with respect to transfers made before November 15, 1958.

97TH CONGRESS
2D SESSION

S. 2479

To amend the Internal Revenue Code of 1954 to treat certain interests as closely held businesses for estate tax purposes, to prevent the acceleration of estate tax installment payments in certain situations, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MAY 4 (legislative day, APRIL 13), 1982

Mr. SYMMS (for himself, Mr. BENTSEN, Mr. BOREN, Mr. HELMS, Mr. JEPSEN, Mr. JOHNSTON, Mr. MATHIAS, Mr. MATTINGLY, Mr. MCCLURE, Mr. NUNN, and Mr. ZORINSKY) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to treat certain interests as closely held businesses for estate tax purposes, to prevent the acceleration of estate tax installment payments in certain situations, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Section 6166 Technical Revision Act of 1982".

SEC. 2. INTEREST IN A CLOSELY HELD BUSINESS.

(a) IN GENERAL.—Paragraph (1) of section 6166(b) of the Internal Revenue Code of 1954 (relating to interest in a closely held business) is amended—

(1) by inserting "or profits interest" after "capital interest" in subparagraph (B)(i),

(2) by striking out "voting" in subparagraph (C)(i),

(3) by striking out "15" in subparagraphs (B)(ii) and (C)(ii) and inserting in lieu thereof "35",

(4) by striking out "or" at the end of subparagraph (B)(ii),

(5) by striking out the period at the end of subparagraph (C)(ii) and inserting in lieu thereof a semicolon, and

(6) by adding at the end thereof the following new subparagraphs:

"(D) that portion of an interest as a partner in a partnership, or of stock in a corporation, included in determining the gross estate of a decedent which bears the same relationship to such partnership interest or stock as the value of any interest in another partnership, stock in another corporation, or interest in minerals which—

"(i) is owned by (or is treated by the application of paragraph (2)(C) as owned by) such partnership or corporation,

"(ii) is treated (by the application of paragraph (2)(C)) as owned by the decedent, and

"(iii) is described in subparagraph (B), (C), (E), or (I),

bears to the value of all assets of such partnership or corporation which are treated (by the application of paragraph (2)(C)) as owned by the decedent;

"(E) an interest in an unincorporated organization described in section 761(a)(2) which is carrying on a trade or business;

"(F) an interest in a note or other evidence of indebtedness issued by a corporation or partnership carrying on a trade or business if—

"(i) such interest had been acquired by the decedent in an exchange of—

"(I) stock of such corporation with such corporation, or

"(II) an interest in such partnership with such partnership, "(ii) the decedent had been a shareholder in such corporation, or a partner in such partnership, at all times during the 1-year period ending on the date of such exchange, and

"(iii) either—

"(I) the value of the interest in such note or evidence of indebtedness is equal to 20 percent or more of the value of such corporation or partnership (determined by treating the interest in such note or evidence of indebtedness as a liability of such corporation or partnership), or

"(II) such corporation or partnership is described in subparagraph (B)(ii), (C)(ii), or (E);

"(G) in the case of a note or other evidence of indebtedness which meets the requirements of paragraph (2)(F), that portion of an interest in such note or evidence of indebtedness issued by a corporation or partnership which bears the same relationship to the interest in such note or evidence of indebtedness included in the estate of the decedent as the value of any interest in another partnership or stock in another corporation which—

"(i) was owned by (or treated by the application of paragraph (2)(C) as owned by) such partnership or corporation on the day before the date on which the decedent acquired such note from such partnership or corporation, and

"(ii) was treated by the application of paragraph (2)(C) as owned by the decedent on the day before the date of such acquisition,

bears to the value of all assets of such partnership or corporation which the decedent was treated as owning (by the application of paragraph (2)(C)) on the day before the date of such acquisition;

"(H) an interest in a note or other evidence of indebtedness issued by a corporation or partnership before the date which is 1 year prior to the date of death of the decedent, but only if—

"(i) such note or evidence of indebtedness is acquired by the decedent in an exchange of money or other property with such partnership or corporation (other than an exchange described in subparagraph (F)(i) or paragraph (2)(F)(ii)),

"(ii) an interest in such partnership or corporation—

"(I) is described in subparagraph (B), (C), (D), or (E) and included in determining the gross estate of the decedent, or

"(II) is described in clauses (i), (ii), and (iii) of subparagraph (D), and

"(iii) such money or other property is used—

"(I) in the case of a note or evidence of indebtedness issued by any partnership or corporation described in subparagrpah (B), (C), or (E), by the partnership or corporation described in such subparagraph in carrying on its trade or business, or

"(II) in the case of a note or evidence of indebtedness issued by any partnership or corporation described in subparagraph (D), by the partnership or corporation described in clauses (i), (ii), and (iii) of subparagraph (D) in carrying on its trade or business;

"(I) an overriding royalty interest, a net profits interest, or other nonoperating interest in minerals which was acquired by the decedent in exchange for—

"(i) services rendered by the decedent in determining the location of such minerals, in acquiring such minerals, or in acquiring a lease of such minerals, or

"(ii) an operating interest in such minerals; or

"(J) an interest in an asset which—

"(i) is leased to, or used by, a corporation or partnership described in subparagraph (B), (C), or (E) or clauses (i), (ii), and (iii) of subparagraph (D), and

"(ii) is used by such corporation or partnership in carrying on the trade or business of such corporation or partnership throughout the 1-year period ending on the date of death of the decedent.".

(b) Attribution Rules and Other Special Rules.—

(1) ATTRIBUTION RULES.—Paragraph (2) of section 6166 of such Code (relating to rules for applying paragraph (1)) is amended to read as follows:

"(2) RULES FOR APPLYING PARAGRAPH (1).—For purposes of paragraph (1)—

"(A) TIME FOR DETERMINATIONS.—Except as otherwise provided in paragraph (1), determinations shall be made as of the time immediately before the death of the decedent.

"(B) NUMERICAL REQUIREMENTS FOR PARTNERSHIPS AND CORPORATIONS.—For purposes of subparagraphs (B)(ii) and (C)(ii) of paragraph (1), all stock and partnership interests held by or (after application of subparagraph (C)) treated as held by—

"(i) an individual,

"(ii) a member of the family of such individual (within the meaning of section 267(c)(4)),

"(iii) the spouse or surviving spouse of an individual described in clause (ii), or

"(iv) the estate of an individual described in clause (ii) or (iii),

shall be treated as owned by one shareholder or one partner, as the case may be.

"(C) INDIRECT OWNERSHIP.—

"(i) IN GENERAL.—Property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

"(ii) SUCCESSIVE APPLICATION.—Property treated as owned by a person by reason of the application of clause (i) shall be treated as owned by such person for purposes of again applying clause (i) in order to treat another person as the owner of such property.

"(iii) BENEFICIARY.—For purposes of this subparagraph, a person shall be treated as a beneficiary of any trust only if such person has a present interest in the trust.

"(D) PERCENTAGE OWNERSHIP REQUIREMENTS FOR PARTNERSHIPS AND CORPORATIONS.—For purposes of subparagraphs (B)(i) and (C)(i) of paragraph (1), all stock and all partnership interests held by or (after the application of subparagraph (C)) treated as held by—

"(i) the decedent,

"(ii) a member of the family of the decedent (within the meaning of section 267(c)(4)),

"(iii) the spouse or surviving spouse of an individual described in clause (ii), or

"(iv) the estate of an individual described in clause (ii) or (iii),

shall be treated as owned by the decedent.

"(E) INTERESTS ATTRIBUTED TO DECEDENT INCLUDED IN GROSS ESTATE.—For purposes of subparagraph (B)(i) and (C)(i) of paragraph (1), any interest treated as owned by the decedent by reason of this paragraph shall be treated as included in determining the gross estate of such decedent.

"(F) REQUIREMENTS FOR HOLDING COMPANY BUY OUT NOTES.—A note or other evidence of indebtedness meets the requirements of this subparagraph if—

"(i) such note or evidence of indebtedness was issued by a partnership or corporation,

"(ii) such note or evidence of indebtedness had been acquired by the decedent in an exchange of—

"(I) stock of such corporation with such corporation, or

"(II) an interest in such partnership with such partnership,

"(iii) the decedent had been a shareholder in such corporation, or a partner in such partnership, at all times during the 1-year period ending on the date of such exchange, and

"(iv) either—

"(I) the value of the interest of the decedent in such note or evidence of indebtedness is equal to 20 percent or more of the value (determined at the time of decedent's death) of the partnership or corporation described in clauses (i) and (ii) of paragraph (1)(G), or

"(II) the partnership or corporation described in clauses (i) and (ii) of paragraph (1)(G) is described in subparagraph (B)(ii), (C)(ii), or (E) at the time of decedent's death.".

(2) CERTAIN ITEMS FOR WHICH MARITAL DEDUCTION WAS ALLOWED; CERTAIN CONTRIBUTIONS.—Subsection (b) of section 6166 of such Code

(relating to definitions and special rules) is amended by striking out paragraph (7) and inserting in lieu thereof the following new paragraphs:

"(7) CERTAIN ITEMS FOR WHICH MARITAL DEDUCTION PREVIOUSLY ALLOWED.—Any item included in the value of the gross estate of the decedent under section 2044 shall be treated as included in determining the gross estate of the decedent for purposes of this section.

"(8) CERTAIN CONTRIBUTIONS NOT USED IN CLOSELY HELD BUSINESS.—For purposes of this section, the value of an interest in a closely held business described in subparagraph (B), (C), (D), or (E) of paragraph (1) shall not include the value of any property or money which—

"(A) is contributed—

"(i) in the case of an interest in a closely held business described in subparagraph (B), (C), or (E) of paragraph (1), to the corporation or partnership described in such subparagraph by or on behalf of the decedent, or

"(ii) in the case of an interest in a closely held business described in paragraph (1)(D), to the corporation or partnership described in clauses (i), (ii), and (iii) of paragraph (1)(D) by or on behalf of—

"(I) the decedent, or

"(II) the corporation or partnership described in subsection (b)(1)(D) (any interest in or stock of which is included in determining the gross estate of the decedent), and

"(B) is not used by the recipient corporation or partnership in carrying on the trade or business of such corporation or partnership throughout the 1-year period ending on the date of death of the decedent.".

(c) INTERESTS IN 2 OR MORE CLOSELY HELD BUSINESSES.—Subsection (c) of section 6166 of such Code (relating to special rule for interests in 2 or more closely held businesses) is amended to read as follows:

"(c) SPECIAL RULE FOR INTERESTS IN 2 OR MORE CLOSELY HELD BUSINESSES.—For purposes of this section, interests in 2 or more closely held businesses included in determining the gross estate of the decedent, each of which—

"(1) has a value which equals or exceeds 5 percent of the adjusted gross estate of the decedent,

"(2) is described in subparagraph (A), (B)(i), (C)(i), or (E) of subsection (b)(1), or

"(3) is described in subsection (b)(1)(D), but only if the interest or stock described in clauses (i) and (ii) of subsection (b)(1)(D) is also described in subparagraph (B)(i), (C)(i), or (E) of subsection (b)(1),

shall be treated as an interest in a single closely held business.".

(d) TECHNICAL AMENDMENT.—Paragraph (3) of section 6166(b) of such Code is amended by striking out "65-percent" and inserting in lieu thereof "35-percent".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to the estates of decedents dying after December 31, 1981.

SEC. 3. ELIMINATION OF THE ACCELERATION OF ESTATE TAX PAYMENTS IN CERTAIN SITUATIONS.

(a) DISPOSITION OR WITHDRAWAL TO PAY CERTAIN DEATH TAXES AND EXPENSES.—Subparagraph (B) of section 6166(g)(1) of the Internal Revenue Code of 1954 (relating to disposition of interest) is amended to read as follows:

"(B) PAYMENT OF CERTAIN DEATH TAXES AND EXPENSES.—

"(i) IN GENERAL.—In the case of any disposition of a portion of an interest in a closely held business, or a withdrawal from such a business of money or other property attributable to such an interest, only the excess of—

"(I) the sum of the amount realized from such disposition (or the amount of money and the fair market value of other property so withdrawn) and the amount by which such interest in the closely held business has been reduced by previous application of clause (iii), over

"(II) the aggregate amount of any taxes, interest, or expenses described in paragraph (1) or (2) of section 303(a) which are paid on or before the final date on which such payment may be made under clause (ii),

shall be treated for purposes of subparagraph (A) as disposed of or withdrawn.

"(ii) Payment period.—For purposes of clause (i), the payment of any tax, interest, or expense described in paragraph (1) or (2) of section 303(a) may be made at any time prior to the date of the disposition or withdrawal described in clause (i), or after such date, but in no event shall such payment be made after the later of—

"(I) the date prescribed by subsection (a)(3) for the payment of the first installment which becomes due after the date of such disposition or withdrawal, or

"(II) the date which is 1 year after the date of such disposition or withdrawal.

"(iii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to any disposition of a portion of an interest in a closely held business or withdrawal from such closely held business occurring after the disposition or withdrawal described in clause (i), the interest in such closely held business shall be considered to be such interest reduced by—

"(I) the amount realized from the disposition described in clause (i), or

"(II) the amount of money and the value of other property withdrawn in the withdrawal described in clause (i), which is not treated as disposed of or withdrawn for purposes of subparagraph (A) by reason of clause (i).".

(b) REORGANIZATIONS.—Subparagraph (C) of section 6166(g)(1) of such Code is amended to read as follows:

"(C) REORGANIZATIONS.—

"(i) IN GENERAL.—In the case of an exchange of shares of stock described in clause (ii), only that portion of the value of the shares of stock exchanged which is equal to the excess, if any, of—

"(I) the fair market value at the time of such exchange of the shares of stock exchanged, over

"(II) the fair market value at the time of such exchange of the shares of stock received in such exchange,

shall be treated for purposes of subparagraph (A) as disposed of, withdrawn, or exchanged.

"(ii) APPLICABLE EXCHANGES.—An exchange of shares of stock is described in this clause if such exchange is an exchange of stock—

"(I) to which section 355 (or so much of section 356 as relates to section 355) applies,

"(II) pursuant to a plan of reorganization described in section 368(a)(1) if the stock received would have qualified as a closely held business interest if owned by the decedent on the date of decedent's death, or

"(III) is described in section 1036.

"(iii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to any disposition or withdrawal occurring after the exchange of stock to which clause (i) applies, any shares of stock received in such an exchange shall be treated as an interest qualifying under subsection (a)(1).".

(c) NO DISQUALIFICATION IN CASE OF SUBSEQUENT DEATHS.—Subparagraph (D) of section 6166(g)(1) of such Code is amended—

(1) by striking out "Subparagraph (A)(i)" and inserting in lieu thereof "SUBSEQUENT TRANSFERS BY REASON OF DEATH.—Subparagraph (A)", and

(2) by striking out the second sentence thereof and inserting in lieu thereof the following new sentence: "A similar rule shall apply in the case of subsequent transfers of the property by reason of the death of such person or of a subsequent transferee.".

(d) Buy Outs and Other Special Rules.—Paragraph (1) of section 6166(g) of such Code (relating to disposition of interest) is amended by adding at the end thereof the following new subparagraphs:

"(E) Certain buy outs.—

"(i) In general.—In the case of a limited exchange of shares of stock of a corporation, or of an interest in a partnership, for a note or other evidence of indebtedness, only that portion of the value of such shares of stock, or of such partnership interest, which is equal to the excess, if any, of—

"(I) the fair market value at the time of such limited exchange of such shares of stock or partnership interest, over

"(II) the face value of any note or other evidence of indebtedness issued by such corporation or partnership which is received in such limited exchange, shall be treated for purposes of subparagraph (A) as disposed of, withdrawn, or exchanged.

"(ii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to any disposition or withdrawal occurring after the limited exchange described in clause (i), any note or other evidence of indebtedness received in such a limited exchange shall be treated as an interest qualifying under subsection (a)(1).

"(F) LIMITED EXCHANGE.—For purposes of this paragraph, the term 'limited exchange' means an exchange of—

"(i) shares of stock of a corporation with—

"(I) such corporation, or

"(II) if such corporation guarantees any note or evidence of indebtedness received in such exchange, any shareholder or employee of such corporation who was a shareholder or employee of such corporation at all times during the period beginning 1 year prior to the date of death of the decedent and ending on the date of such exchange, or "(ii) an interest in a partnership with—

"(I) such partnership, or

"(II) if such partnership guarantees any note or evidence of indebtedness received in such exchange, any partner in, or employee of, such partnership who was a partner in, or employee of, such partnership at all times during the period beginning 1 year prior to the date of death of the decedent and ending on the date of such exchange.

For purposes of this subparagraph, the term 'employee' has the meaning given such term in paragraph (1) or (2) of section 3121(d).

"(G) SPECIAL RULES FOR NOTES.—For purposes of this paragraph—

"(i) PAYMENT OF INTEREST.—The payment of interest on any note or evidence of indebtedness described in subparagraph (F), (G), or (H) of subsection (b)(1) or subparagraph (E) of this paragraph shall not be treated as a withdrawal from a closely held business or a disposition of an interest in a closely held business.

"(ii) PAYMENT OF PRINCIPAL.—The payment of any portion of the principal on any note or evidence of indebtedness described in subparagraph (F) or (H) of subsection (b)(1) or subparagraph (E) of this paragraph shall be treated as a withdrawal from a closely held business.

"(iii) DISPOSITION OF HOLDING COMPANY BUY-OUT NOTE.—If any portion of an interest in a note or other evidence of indebtedness which is described in subsection (b)(1)(G) qualifies under subsection (a)(1)—

"(I) a disposition of any interest in such note or evidence of indebtedness which was included in determining the gross estate of the decedent, or

"(II) any payment of principal attributable to an interest in such note or evidence of indebtedness included in determining the gross estate of the decedent,

shall be treated for purposes of this paragraph as a disposition of (or a withdrawal with respect to) the portion of such interest qualifying under subsection (a)(1) in an amount equal to that portion of the amount realized from such disposition (or of the amount of such payment of principal) which bears the same relationship to the amount so realized (or the amount of such payment of principal) as the relationship described in subsection (b)(1)(G).

"(iv) READILY TRADABLE NOTES.—If any note or other evidence of indebtedness described in subparagraph (F), (G), or (H) of subsection (b)(1) or subparagraph (E) of this paragraph becomes readily tradable (within the meaning of section 453(f)(5)), the entire interest qualifying under subsection (a)(1) in such note or evidence of indebtedness shall be treated as having been disposed of on the first day such note or evidence of indebtedness becomes readily tradable.

"(v) DISPOSITION BY HOLDING COMPANY OF CERTAIN ENTITY ACTIVELY CARRYING ON TRADE OR BUSINESS.—In the case of any interest in a note or other evidence of indebtedness issued by a partnership or corporation which is described in subsection (b)(1)(G) and which qualifies under subsection (a)(1)—

"(I) any disposition of any portion of the interest or the stock described in clauses (i) and (ii) of subsection (b)(1)(G) by such partnership or corporation or by any other partnership, corporation, estate, or trust through which such partnership or corporation was treated (by the application of subsection (b)(2)(C)) as owning the interest or stock described in clauses (i) and (ii) of subsection (b)(1)(G), or

"(II) any withdrawal with respect to the interest or stock described in clauses (i) and (ii) of subsection (b)(1)(G) by such partnership or corporation or by such other partnership, corporation, estate, or trust,

shall be treated for purposes of subparagraph (A) as a disposition of that portion of such note or evidence of indebtedness qualifying under subsection (a)(1) which bears the same relationship to such note or evidence of indebtedness qualifying under subsection (a)(1) as the amount realized from the disposition of such portion of the interest or stock described in clauses (i) and (ii) of subsection (b)(1)(G) (or the amount of money and the value of other property so withdrawn) bears to the fair market value (at the time immediately before such disposition or withdrawal) of the entire interest or stock described in such clauses.".

"(vi) ACQUISITION OF THE ISSUER OR GUARANTOR OF A NOTE.—In the case of a note or other evidence of indebtedness which—

"(I) was acquired in an exchange of stock of a corporation, or of an interest in a partnership, described in paragraph (1)(F) or (2)(F) of subsection (b) or subparagraph (E) of this paragraph, or

"(II) was issued to the decedent by a corporation or partnership described in subsection (b)(1)(H),

the qualified acquisition of such corporation or partnership by another corporation whose stock is readily tradable and which guarantees or assumes liability on such note or evidence of indebtedness shall be treated as a disposition of the entire interest in such note or evidence of indebtedness which qualifies under subsection (a)(1).

"(vii) QUALIFIED ACQUISITION.—The term 'qualified acquisition of a corporation' means an acquisition of at least 50 percent of—

"(I) the total combined voting power of all classes of stock of such corporation which are entitled to vote,

"(II) the total value of shares of all classes of stock of such corporation, or

"(III) the fair market value (determined at the time of such acquisition) of all assets of such corporation used in carrying on the trade or business of such corporation.

"(viii) READILY TRADABLE STOCK.—Stock is readily tradable if, at the time of a qualified acquisition, there is a market for such stock on any stock exchange or in any over-the-counter market.

"(H) NOTE ISSUED BY AND ASSETS USED BY A DISPOSED CLOSELY HELD BUSINESS.—If the entire interest in a partnership, or all the stock in a corporation, described in subparagraph (B), (C), (D), or (E) of subsection (b)(1) which qualifies under subsection (a)(1) is treated under subparagraph (A) as having been disposed of (or an amount of money and other property attributable to such interest or stock and equal in value to such interest or stock is treated under subparagraph (A) as having been withdrawn from the closely held business), the entire interest in—

"(i) any note or evidence of indebtedness described in subsection (b)(1)(H) which is issued by such partnership or corporation (or by a partnership or corporation described in clauses (i), (ii), and (iii) of subsection (b)(1)(D)), and

"(ii) any asset described in subsection (b)(1)(J) which is leased to, or used by, such partnership or corporation (or the partnership or corporation described in clauses (i), (ii), and (iii) of subsection (b)(1)(D)),

shall be treated, for purposes of this paragraph, as having been disposed of or exchanged on the date on which such disposal or withdrawal of the interest in such partnership or the stock in such corporation is treated under subparagraph (A) as occurring.

"(I) INVOLUNTARY CONVERSIONS.—

"(i) CONVERSION INTO SIMILAR PROPERTY.—Subparagraph (A) shall not apply to any involuntary conversion of a portion of an interest in a closely held business which is described in section 1033(a)(1). For purposes of applying subparagraph (A) to subsequent dispositions or withdrawals, any interest in the property into which an interest in a closely held business was so converted shall be treated as an interest qualifying under subsection (a)(1).

"(ii) CONVERSION INTO OTHER PROPERTY.—In the case of an involuntary conversion of any portion of an interest in a closely held business which is described in section 1033(a)(2), only the excess, if any, of—

"(I) the amount realized on the conversion of such interest, over

"(II) the cost of qualified replacement property,

shall be treated, for purposes of subparagraph (A), as disposed of, withdrawn, or exchanged. For purposes of subsequent application of subparagraph (A), any interest in qualified replacement property shall be treated as an interest qualifying under subsection (a)(1).

"(iii) QUALIFIED REPLACEMENT PROPERTY.—For purposes of this subparagraph, the term 'qualified replacement property' means any property similar or related in service or use to the converted property which is acquired for the purpose of replacing the converted property by the executor of the estate of the decedent during the period which begins on the earliest date of the threat or imminence of requisition or condemnation and ends on the date which is 1 year after the date on which any part of the gain upon the conversion is realized.

"(J) LIKE KIND EXCHANGES.—

"(i) EXCHANGES SOLELY IN LIKE KIND.—Subparagraph (A) shall not apply to any exchange described in section 1031(a) in which an interest in a closely held business is exchanged for qualified exchange property.

"(ii) EXCHANGES NOT SOLELY IN LIKE KIND.—In the case of an exchange described in section 1031(b) in which an interest in a closely held business is exchanged, only that portion of such interest which is equal to the excess, if any, of—

"(I) the fair market value of such interest at the time of such exchange, over

"(II) the fair market value of qualified exchange property received in such exchange at the time of such exchange,

shall be treated for purposes of subparagraph (A) as disposed of, withdrawn, or exchanged.

"(iii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to subsequent dispositions or withdrawals, any interest in qualified exchange property shall be treated as an interest qualifying under subsection (a)(1).

"(iv) QUALIFIED EXCHANGE PROPERTY.—For purposes of this subparagraph, the term 'qualified exchange property' means property received in an exchange which, if it were the only property received in such exchange, would result in nonrecognition of gain or loss under section 1031(a).

"(K) DISPOSITION OF HOLDING COMPANY INTEREST.—If any portion of an interest in a partnership, or of stock in a corporation, which is described in subsection (b)(1)(D) qualifies under subsection (a)(1)—

"(i) a disposition of any interest in such partnership, or stock in such corporation, which was included in determining the gross estate of the decedent, or

"(ii) a withdrawal of any money or other property from such partnership or corporation attributable to any interest included in determining the gross estate of the decedent,

shall be treated for purposes of this paragraph as a disposition of (or a withdrawal with respect to) the portion of such interest or stock qualifying under subsection (a)(1) in an amount equal to that portion of the amount realized from such disposition (or of the amount of money and the value of other property so withdrawn) which bears the same relationship to the amount so realized (or so withdrawn) as the relationship described in subsection (b)(1)(D).

"(L) DISPOSITION BY HOLDING COMPANY OF CERTAIN ENTITY ACTIVELY CARRYING ON TRADE OR BUSINESS.—In the case of any interest in a partnership, or stock in a corporation, which is described in subsection (b)(1)(D) and which qualifies under subsection (a)(1)—

"(i) any disposition of any portion of an interest or of stock described in clauses (i), (ii), and (iii) of subsection (b)(1)(D) by such partnership or corporation or by any other partnership, corporation, estate, or trust through which such partnership or corporation was treated (by the application of subsection (b)(2)(C)) as owning such interest or stock described in clauses (i), (ii), and (iii) of subsection (b)(1)(D), or

"(ii) any withdrawal with respect to the interest or stock described in clauses (i), (ii), and (iii) of subsection (b)(1)(D) by such partnership or corporation or by such other partnership, corporation, estate, or trust,

shall be treated for purposes of subparagraph (A) as a disposition of that portion of such interest or stock qualifying under subsection (a)(1) which bears the same relationship to such interest or stock qualifying under subsection (a)(1) as the amount realized from the disposition of such portion of the interest or stock described in clauses (i), (ii), and (iii) of subsection (b)(1)(D) (or the amount of money and the value of other property so withdrawn) bears to the fair market value (at the time immediately before such disposition or withdrawal) of the entire interest or stock described in such clauses.".

(e) CONFORMING AMENDMENTS.—

(1) Subparagraph (A) of section 6166(g)(1) of such Code (relating to dispositions and withdrawals) is amended by striking out "(A) If" and inserting in lieu thereof "(A) IN GENERAL.—If".

(2) Paragraph (2) of section 6166(g) of such Code (relating to undistributed income of estate) is amended—

(A) by striking out "(A) If" in subparagraph (A) and inserting in lieu thereof "(A) IN GENERAL.--If", and

(B) by striking out "(B) For" in subparagraph (B) and inserting in lieu thereof "(B) UNDISTRIBUTED NET INCOME.—For".

(f) COORDINATION WITH SECTION 6166A.—

(1) DISPOSITION OR WITHDRAWAL TO PAY CERTAIN DEATH TAX AND EXPENSES.—Subparagraph (B) of section 6166A(h)(1) of such Code (relating to disposition of interest), as in effect on the day before the date of enactment of the Economic Recovery Tax Act of 1981, is amended to read as follows:

"(B) PAYMENT OF CERTAIN DEATH TAXES AND EXPENSES.—

"(i) IN GENERAL.—In the case of any disposition of a portion of an interest in a closely held business, or a withdrawal from such a business of money or other property attributable to such an interest, only the excess of—

"(I) the sum of the amount realized from such disposition (or the amount of money and the fair market value of other property so withdrawn) and the amount by which such interest in the closely held business has been reduced by previous application of clause (iii), over

"(II) the aggregate amount of any taxes, interest, or expenses described in paragraph (1) or (2) of section 303(a) which are paid on or before the final date on which such payment may be made under clause (ii),

shall be treated for purposes of subparagraph (A) as disposed of or withdrawn.

"(ii) PAYMENT PERIOD.—For purposes of clause (i), the payment of any tax, interest, or expense described in paragraph (1) or (2) of section 303(a) may be made at any time prior to the date of the disposition or withdrawal described in clause (i), or after such date, but in no event shall such payment be made after the later of—

"(I) the date prescribed by subsection (a)(3) for the payment of the first installment which becomes due after the date of such disposition or withdrawal, or

"(II) the date which is 1 year after the date of such disposition or withdrawal.

"(iii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to any disposition of a portion of an interest in a closely held business or withdrawal from such closely held business occurring after the disposition or withdrawal described in clause (i), the interest in such closely held business shall be considered to be such interest reduced by—

"(I) the amount realized from the disposition described in clause (i), or

"(II) the amount of money and the value of other property withdrawn in the withdrawal described in clause (i),

which is not treated as disposed of or withdrawn for purposes of subparagraph (A) by reason of clause (i).".

(2) REORGANIZATIONS.—Subparagraph (C) of section 6166A(h)(1) of such Code, as in effect on the day before the date of enactment of the Economic Recovery Tax Act of 1981, is amended to read as follows:

"(C) REORGANIZATIONS.—

"(i) IN GENERAL.—In the case of an exchange of shares of stock described in clause (ii), only that portion of the value of the shares of stock exchanged which is equal to the excess, if any, of—

"(I) the fair market value at the time of such exchange of the shares of stock exchanged, over

"(II) the fair market value at the time of such exchange of the shares of stock received in such exchange,

shall be treated for purposes of subparagraph (A) as disposed of, withdrawn, or exchanged.

"(ii) APPLICABLE EXCHANGES.—An exchange of shares of stock is described in this clause if such exchange is an exchange of stock—

"(I) to which section 355 (or so much of section 356 as relates to section 355) applies,

"(II) pursuant to a plan of reorganization described in section 368(a)(1) if the stock received would have qualified as a closely held business interest if owned by the decedent on the date of decedent's death, or

"(III) is described in section 1036.

"(iii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to any disposition or withdrawal occurring after the exchange of stock to which clause (i) applies, any shares of stock received in such an exchange shall be treated as an interest qualifying under subsection (a)(1).".

(3) NO DISQUALIFICATION IN CASE OF SUBSEQUENT DEATHS.—Subparagraph (D) of section 6166A(h)(1) of such Code, as in effect on the day before the date of enactment of the Economic Recovery Tax Act of 1981, is amended—

(A) by striking out "Subparagraph (A)(ii)" and inserting in lieu thereof "SUBSEQUENT TRANSFERS BY REASON OF DEATH.—Subparagraph (A)", and

(B) by adding at the end thereof the following new sentence: "A similar rule shall apply in the case of subsequent transfers of the property by reason of the death of such person or of a subsequent transferee.".

(4) BUY OUTS AND OTHER SPECIAL RULES.—Paragraph (1) of section 6166A(h) of such Code (relating to disposition of interest), as in effect on the day before the date of enactment of the Economic Recovery Tax Act of 1981, is amended by adding at the end thereof the following new subparagraphs:

"(E) CERTAIN BUY OUTS.—

"(i) IN GENERAL.—In the case of a limited exchange of shares of stock of a corporation, or of an interest in a partnership, for a note or other evidence of indebtedness, only that portion of the value of such shares of stock, or of such partnership interest, which is equal to the excess, if any, of—

"(I) the fair market value at the time of such limited exchange of such shares of stock or partnership interest, over

"(II) the face value of any note or other evidence of indebtedness issued by such corporation or partnership which is received in such limited exchange,

shall be treated for purposes of subparagraph (A) as disposed of, withdrawn, or exchanged.

"(ii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to any disposition or withdrawal occurring after the limited exchange described in clause (i), any note or other evidence of indebtedness received in such a limited exchange shall be treated as an interest qualifying under subsection (a)(1).

"(F) LIMITED EXCHANGE.—For purposes of this paragraph, the term 'limited exchange' means an exchange of—

"(i) shares of stock of a corporation with—

"(I) such corporation, or

"(II) if such corporation guarantees any note or evidence of indebtedness received in such exchange, any shareholder or employee of such corporation who was a shareholder or employee of such corporation at all times during the period beginning 1 year prior to the date of death of the decedent and ending on the date of such exchange, or

"(ii) an interest in a partnership with—

"(I) such partnership, or

"(II) if such partnership guarantees any note or evidence of indebtedness received in such exchange, any partner in, or employee of, such partnership who was a partner in, or employee of, such partnership at all times during the period beginning 1 year prior to the date of death of the decedent and ending on the date of such exchange.

For purposes of this subparagraph, the term 'employee' has the meaning given such term in paragraph (1) or (2) of section 3121(d).

"(G) SPECIAL RULES FOR BUY OUT NOTES.—For purposes of this paragraph—

"(i) PAYMENT OF INTEREST.—The payment of interest on any note or evidence of indebtedness described in subparagraph (E) shall not be treated as a withdrawal from a closely held business or a disposition of an interest in a closely held business.

"(ii) PAYMENT OF PRINCIPAL.—The payment of any portion of the principal on any note or evidence of indebtedness described in subparagraph (E) shall be treated as a withdrawal from a closely held business.

"(iii) READILY TRADABLE NOTES.—If any note or other evidence of indebtedness described in subparagraph (E) of this paragraph becomes readily tradable (within the meaning of section 453(f)(5)), the entire interest qualifying under subsection (a)(1) in such note or evidence of indebtedness shall be treated as having been disposed of on the first day such note or evidence of indebtedness becomes readily tradable.

"(iv) ACQUISITION OF ISSUER OR GUARANTOR OF NOTE.—In the case of a note or other evidence of indebtedness which was acquired in an exchange of stock of a corporation, or of an interest in a partnership, described in subparagraph (E), the qualified acquisition of such corporation or partnership by another corporation whose stock is readily tradable and which guarantees or assumes liability on such note or evidence of indebtedness shall be treated as a disposition of the entire interest in such note or evidence of indebtedness.

"(v) QUALIFIED ACQUISITION.—The term 'qualified acquisition of a corporation' means an acquisition of at least 50 percent of—

"(I) the total combined voting power of all classes of stock of such corporation which are entitled to vote,

"(II) the total value of shares of all classes of stock of such corporation, or

"(III) the fair market value (determined at the time of such acquisition) of all assets of such corporation used in carrying on the trade or business of such corporation.

"(vi) READILY TRADABLE STOCK.—Stock is readily tradable if, at the time of a qualified acquisition, there is a market for such stock on any stock exchange or in any over-the-counter market.

"(H) INVOLUNTARY CONVERSIONS.—

"(i) CONVERSION INTO SIMILAR PROPERTY.—Subparagraph (A) shall not apply to any involuntary conversion of a portion of an interest in a closely held business which is described in section 1033(a)(1). For purposes of applying subparagraph (A) to subsequent dispositions or withdrawals, any interest in the property into which an interest in a closely held business was so converted shall be treated as an interest qualifying under subsection (a)(1).

"(ii) CONVERSION INTO OTHER PROPERTY.—In the case of an involuntary conversion of any portion of an interest in a closely held business which is described in section 1033(a)(2), only the excess, if any, of—

"(I) the amount realized on the conversion of such interest, over

"(II) the cost of qualified replacement property,

shall be treated, for purposes of subparagraph (A), as disposed of, withdrawn, or exchanged. For purposes of subsequent application of subparagraph (A), any interest in qualified replacement property shall be treated as an interest qualifying under subsection (a)(1).

"(iii) QUALIFIED REPLACEMENT PROPERTY.—For purposes of this subparagraph, the term 'qualified replacement property' means any property similar or related in service or use to the property converted which is acquired for the purpose of replacing the converted property by the executor of the estate of the decedent during the period which begins on the earliest date of the threat or imminence of requisition or condemnation and ends on the date which is 1 year after the date on which any part of the gain upon the conversion is realized.

"(I) LIKE KIND EXCHANGES.—

"(i) EXCHANGES SOLELY IN LIKE KIND.—Subparagraph (A) shall not apply to any exchange described in section 1031(a) in which an interest in a closely held business is exchanged for qualified exchange property.

"(ii) EXCHANGES NOT SOLELY IN LIKE KIND.—In the case of an exchange described in section 1031(b) in which an interest in a closely held business is exchanged, only that portion of such interest which is equal to the excess, if any, of—

"(I) the fair market value of such interest at the time of such exchange, over

"(II) the fair market value of qualified exchange property received in such exchange at the time of such exchange,

shall be treated for purposes of subparagraph (A) as disposed of, withdrawn, or exchanged.

"(iii) SUBSEQUENT DISPOSITIONS AND WITHDRAWALS.—For purposes of applying subparagraph (A) to subsequent dispositions or withdrawals, any interest in qualified exchange property shall be treated as an interest qualifying under subsection (a)(1).

"(iv) QUALIFIED EXCHANGE PROPERTY.—For purposes of this subparagraph, the term 'qualified exchange property' means property received in an exchange which if it were the only property received in such exchange would result in nonrecognition of gain or loss under section 1031(a).".

(5) FAILURE TO MAKE PAYMENTS.—Paragraph (3) of section 6166A(h) of such Code (relating to failure to pay installments), as in effect on the day before the enactment of the Economic Recovery Tax Act of 1981, is amended to read as follows:

"(3) FAILURE TO MAKE PAYMENT OF PRINCIPAL OR INTEREST.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), if any payment of principal or interest under this section is not paid on or before the date fixed for its payment by this section (including any extension of time), the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.

"(B) PAYMENT WITHIN 6 MONTHS.—If any payment of principal or interest under this section is not paid on or before the date determined under subparagraph (A) but is paid within 6 months of such date—

"(i) the provisions of subparagraph (A) shall not apply with respect to such payment,

"(ii) the provisions of section 6601(j) shall not apply with respect to the determination of interest on such payment, and

"(iii) there is imposed a penalty in an amount equal to the product of—

"(I) 5 percent of the amount of such payment, multiplied by

"(II) the number of months (or fractions thereof) after such date and before payment is made.

The penalty imposed under clause (iii) shall be treated in the same manner as a penalty imposed under subchapter B of chapter 68.".

(g) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply with respect to dispositions and withdrawals made after December 31, 1981.

(2) SECTION 6166A.—The amendments made by subsection (e) shall apply to estates of decedents dying before January 1, 1982, with respect to dispositions and withdrawals made after December 31, 1981.

SEC. 4. INTEREST ON ESTATE TAX FOR WHICH PAYMENT IS EXTENDED UNDER SECTION 6166.

(a) FIXED RATE OF INTEREST.—

(1) IN GENERAL.—Paragraph (1) of section 6601(j) of the Internal Revenue Code of 1954 (relating to the 4-percent rate on certain portion of estate tax) is amended to read as follows:

"(1) IN GENERAL.—If the time for payment of an amount of tax imposed by chapter 11 is extended under section 6166, interest shall be paid (in lieu of the annual rate under subsection (a))—

"(A) at a rate of 4 percent on the 4-percent portion of such amount, and

"(B) at the qualified rate on the portion of such amount which is in excess of the 4-percent portion.".

(2) QUALIFIED RATE DEFINED.—Subsection (j) of section 6601 of such Code is amended—

(A) by striking out "4-PERCENT RATE ON CERTAIN PORTION OF" in the caption thereof and inserting in lieu thereof "INTEREST RATE ON", and

(B) by adding at the end thereof the following new paragraphs:

"(4) QUALIFIED RATE.—

"(A) IN GENERAL.—For purposes of this subsection, the term 'qualified rate' means the rate which is equal to the average yield to maturity (as determined by the Secretary) during the month of December in the calendar year preceding the calendar year in which the decedent died on all outstanding obligations of the United States that mature during the month of December in the calendar year which is 13 years after the calendar year in which the decedent died, rounded to the nearest full percentage point.

"(B) DETERMINATION OF AVERAGE YIELD.—The Secretary shall determine the average yield to maturity on obligations described in subparagraph (A) for the month of December 1971, and for each month of December thereafter. Such average yield to maturity for each month of December in the years 1971 through 1981 shall be published in the Federal Register no later than by October 1, 1982, and such average yield to maturity for the month of December 1982, and for each month of December thereafter, shall be so published no later than by March 1 of the succeeding calendar year.

"(5) DEFICIENCIES.—For purposes of this subsection, the amount of any deficiency which is prorated to installments payable under section 6166 shall be treated as an amount of tax payable in installments under such section.".

(b) ESTATE TAX DEDUCTION FOR INTEREST ON ESTATE TAXES.—

(1) IN GENERAL.—Section 2053 of such Code (relating to expenses, indebtedness, and taxes) is amended by redesignating subsection (e) as subsection

(f) and inserting after subsection (d) the following new subsection:

"(e) INTEREST ON CERTAIN TAXES.—In the case of an estate which elects to pay any portion of the tax imposed by section 2001 in installments under section 6166—

"(1) IN GENERAL.—For purposes of this section, there shall be treated as an administration expense an amount of interest which the executor of such estate estimates (at such time as the Secretary shall by regulations prescribe) will be paid or will accrue on—

"(A) any portion of the tax imposed by section 2001 on such estate for which the time of payment is extended under section 6166, or

"(B) any estate, succession, legacy, or inheritance tax imposed by a State on such estate,

during the period of the extension of time for payment provided under section 6166.

"(2) ADJUSTMENT TO TAXABLE ESTATE.—Proper adjustments in the taxable estate shall be made, under regulations prescribed by the Secretary, to take into account any difference between the estimate made under paragraph (1) and the actual amount of interest paid or accrued on the taxes described in paragraph (1) during the period of the extension of time for payment provided under section 6166.".

(2) SUSPENSION OF PERIOD OF LIMITATIONS ON ASSESSMENT.—Subsection (d) of section 6503 of such Code (relating to extensions of time for payment of estate tax) is amended to read as follows:

"(d) EXTENSIONS OF TIME FOR PAYMENT OF ESTATE TAX.—

"(1) ASSESSMENTS.—The running of the period of limitations under section 6501 on the making of assessments with respect to any tax imposed by chapter 11 which are due to adjustments in the taxable estate made under section 2053(e)(2) shall be suspended for the period of any extension of time for payment granted under section 6166.

"(2) COLLECTIONS.—The running of the period of limitations under sections 6501 and 6502 for collection of any tax imposed by chapter 11 shall be suspended for the period of any extension of time for payment granted under the provisions of subsection (a)(2) or (b)(2) of section 6161 or under the provisions of section 6163 or 6166.".

(c) EFFECTIVE DATES AND SPECIAL RULES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to the estates of decedents dying after December 31, 1981.

(2) CERTAIN ESTATES.—

(A) INTEREST RATE.—The amendments made by subsection (a) shall apply to estates described in subparagraph (D) with respect to amounts outstanding on January 1, 1982, or arising after such date.

(B) DEDUCTION FOR INTEREST.—The amendment made by subsection (b)(1) shall apply to estates described in subparagraph (D) with respect to estimates of interest which will accrue or be paid after December 31, 1981.

(C) ASSESSMENTS.—The amendment made by subsection (b)(2) shall apply to estates described in subparagraph (D).

(D) REQUIREMENTS.—The estate of a decedent is described in this subparagraph if—

(i) the decedent died before January 1, 1982,

(ii) the time for payment of any portion of the tax imposed by section 2001 of the Internal Revenue Code of 1954 on such estate is extended, or may be extended, under section 6166 of such Code or section 6166A of such Code (as in effect with respect to estates of decedents dying before January 1, 1982), and

(iii) the executor of such estate elects to have this paragraph apply to such estate (at such time and in such manner as the Secretary of the Treasury shall prescribe by regulations).

The executor of an estate otherwise eligible under this subparagraph to elect the application of this paragraph may elect the application of this paragraph regardless of whether such estate was allowed a deduction under subtitle A of such Code for administration expenses paid or accrued prior to January 1, 1982.

(3) EXTENSIONS UNDER SECTION 6166A.—

(A) IN GENERAL.—Except as otherwise provided in subparagraph (B), for purposes of applying sections 2053(e), 6601(j), and 6503(d) of such Code with respect to an estate described in paragraph (2)(D)—

(i) any extension of the time for payment of the tax imposed by chapter 11 of such Code under section 6166A of such Code (as in effect with respect to estates of decedents dying before January 1, 1982) shall be treated as an extension of the time for payment of such tax under section 6166 of such Code, and

(ii) any election under section 6166A of such Code shall be treated as an election under section 6166 of such Code.

(B) SPECIAL RULE FOR INTEREST RATE.—For purposes of applying subsection (j) of section 6601 of such Code with respect to an estate described in paragraph (2)(D) whose executor elected the application of section 6166A of such Code, the 4-percent portion shall be zero.

SEC. 5. DECLARATORY JUDGMENTS RELATING TO SECTION 6166.

(a) IN GENERAL.—Part IV of subchapter C of chapter 76 of the Internal Revenue Code of 1954 (relating to declaratory judgments) is amended by adding at the end thereof the following new section:

"SEC. 7479. DECLARATORY JUDGMENTS RELATING TO SECTION 6166.

"(a) IN GENERAL.—In the case of an actual controversy involving—

"(1) the extent, if any, to which an estate is eligible for the extension of time for payment of the estate tax provided by section 6166, or

"(2) whether there is an acceleration of the time for payment under section 6166(g),

upon the filing of an appropriate pleading, the Tax Court may make a declaration with respect to such issue. Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

"(b) LIMITATIONS.—

"(1) PETITIONER.—A pleading may be filed under this section only by the executor of the decedent's estate.

"(2) EXHAUSTION OF ADMINISTRATIVE REMEDIES.—The court shall not issue a declaratory judgment under this section unless it determines that the petitioner has exhausted all available administrative remedies within the Internal Revenue Service.

"(3) TIME FOR BRINGING ACTION.—If the Secretary sends by certified or registered mail notice of his determination of an issue described in subsection (a), no proceeding may be initiated under this section with respect to such issue unless the pleading is filed before the 91st day after the date of such mailing.

"(c) RESTRICTION ON COLLECTION AND LEVY OF ESTATE TAX.—

"(1) IN GENERAL.—Except as provided in subchapter A of chapter 70, if the executor of an estate files a petition with the Tax Court under subsection (a), no levy or proceeding in court for the collection of the tax imposed by chapter 11 on such estate shall be made, begun, or prosecuted until the decision of the Tax Court has become final (within the meaning of section 7481).

"(2) Payments under section 6166.—This subsection shall not apply with respect to an estate if the executor of such estate fails to make any payment of principal or interest under section 6166 on or before the date which is six months after the date on which such payment would be required under section 6166 (as determined under section 6166(g)(3)(A)) if—

"(A) in the case of a controversy involving eligibility under section 6166, such estate were eligible for the extension of time for payment under section 6166, or

"(B) in the case of a controversy involving acceleration, such acceleration did not apply to such estate.".

(b) Penalty for Frivolous or Groundless Proceedings or Proceedings for Delay.—

(1) Tax court.—The first sentence of section 6673 of such Code (relating to damages assessable by instituting proceedings before the Tax Court merely for

delay) is amended to read as follows: "Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $2,500 shall be awarded to the United States by the Tax Court in its decision.".

(2) APPEALS.—Paragraph (4) of section 7482 (c) of such Code (relating to imposition of damages) is amended to read as follows:

"(4) TO IMPOSE DAMAGES.—The United States Court of Appeals and the Supreme Court shall have the power to impose damages in any case in which the decision of the Tax Court is affirmed and it appears that the notice of appeal was filed primarily for delay or that the taxpayer's position in such appeal was frivolous or groundless.".

(c) ADDITION TO ESTATE TAX FOR AMOUNT OF PAYMENT WHICH TAX COURT DETERMINES IS NOT EXTENDED OR IS ACCELERATED UNDER SECTION 6166.—

(1) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS.—Paragraph (1) of section 6653(a) of such Code (relating to negligence or intentional disregard of rules and regulations) is amended to read as follows:

"(1) IN GENERAL.—If any part of—

"(A) any underpayment (as defined in subsection (c)(1)(A)) of any tax imposed by subtitle A, by chapter 12, or by chapter 45, or

"(B) any underpayment (as defined in subsection (c)(1)(B)) of any tax imposed under chapter 11,

is due to negligence or intentional disregard of rules or regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.".

(2) UNDERPAYMENT DEFINED.—Paragraph (1) of section 6653(c) of such Code (relating to underpayment) is amended to read as follows:

"(1) INCOME, ESTATE, GIFT, AND CERTAIN EXCISE TAXES.—

"(A) DEFICIENCY.—In the case of a tax to which section 6211 (relating to income, estate, gift, and certain excise taxes) is applicable, a deficiency as defined in that section (except that, for this purpose, the tax shown on a return referred to in section 6211(a)(1)(A) shall be taken into account only if such return was filed on or before the last day prescribed for the filing of such return, determined with regard to any extension of time for such filing), and

"(B) PAYMENT OF ESTATE TAX.—That portion of the tax imposed under chapter 11—

"(i) which is not paid on the date prescribed by section 6151(a) for the payment of such tax (including any extensions of time granted by the Secretary), and

"(ii) with respect to which there is a determination in a decision of the Tax Court under section 7479 which has become final (within the meaning of section 7481) that the time for payment of such portion—

"(I) is not extended under section 6166(a), or

"(II) is accelerated under section 6166(g), and".

(d) CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 7456 of such Code (relating to Tax Court commissioners) is amended by striking out "and 7478" and inserting in lieu thereof "7478, and 7479".

(2) Paragraph (1) of section 7482(b) of such Code (relating to venue) is amended—

(A) by striking out "or" at the end of subparagraph (D),

(B) by striking out the period at the end of subparagraph (E) and inserting in lieu thereof ", or",

(C) by inserting after subparagraph (E) the following new subparagraph:

"(F) in the case of an executor of the estate of a decedent seeking a declaratory decision under section 7479, the legal residence of the decedent.", and

(D) by striking out "or 7477" in the last sentence thereof and inserting in lieu thereof "7477, or 7479".

(3) Subsection (a) of section 7485 (relating to bond to stay assessment and collection) is amended to read as follows:

"(a) UPON NOTICE OF APPEAL.—Notwithstanding any provision of law imposing restrictions on the assessment and collection of taxes, the review under section 7483 shall not operate as a stay of assessment or collection of any portion of the amount of the deficiency determined by the Tax Court (or of any portion of estate tax for which the Tax Court determines the time for payment is not extended under section 6166 or is accelerated under section 6166(g)) unless a notice of appeal in respect of such portion is duly filed by the taxpayer, and then only if the taxpayer—

"(1) on or before the time his notice of appeal is filed, has filed with the Tax Court a bond in a sum fixed by the Tax Court not exceeding double the amount of such portion in respect of which the notice of appeal is filed, and with surety approved by the Tax Court, conditioned upon the payment of the deficiency (or of such portion of estate tax) as finally determined, together with any interest, additional amounts, or additions to the tax provided for by law, or

"(2) has filed a jeopardy bond under the income or estate tax laws.

If as a result of a waiver of the restrictions on the assessment and collection of a deficiency (or of such portion of estate tax) any part of the amount determined by the Tax Court is paid after the filing of the appeal bond, such bond shall, at the request of the taxpayer, be proportionately reduced.".

(4) Paragraph ([illegible]) of section 6503(d) of such Code (relating to extensions of time for payment of estate tax), as amended by section 4(b)(2) of this Act, is amended to read as follows:

"(1) ASSESSMENTS.—The running of the period of limitations under section 6501 on the making of assessments with respect to any tax imposed by chapter 11 which are due to—

"(A) adjustments in the taxable estate made under section 2053(e)(2), or

"(B) additions to tax made under section 6653 with respect to an underpayment (within the meaning of section 6653(c)(1)(B)(ii)(II)),

shall be suspended for the period of any extension of time for payment granted under section 6166.".

(5) Subsection (a) of section 6653 of such Code (relating to failure to pay tax) is amended by striking out "Income, Gift, or Windfall Profit" in the caption thereof and inserting in lieu thereof "Certain".

(6) The table of sections for part IV of subchapter C of chapter 76 of such Code is amended by adding at the end thereof the following new item:

"Sec. 7479. Declaratory judgments relating to section 6166."

(e) EFFECTIVE DATES AND SPECIAL RULE.—

(1) DECLARATORY JUDGMENT.—

(A) IN GENERAL.—Except as provided in subparagraph (B), the amendment made by subsection (a) shall apply with respect to the estates of decedents dying after December 31, 1981.

(B) ACCELERATION.—In the case of an actual controversy with respect to whether there is acceleration under section 6166(g) or 6166A(h) of such Code, the amendment made by subsection (a) shall apply with respect to dispositions and withdrawals made after December 31, 1981.

(2) TAX COURT PENALTY.—The amendment made by subsection (b)(1) shall apply to pleadings filed with the Tax Court after the date of enactment of this Act.

(3) APPEALS FROM TAX COURT.—The amendments made by subsection (b)(2) and paragraphs (2) and (3) of subsection (d) shall apply with respect to notices of appeal filed after the date of enactment of this Act.

(4) ADDITION TO ESTATE TAX; CERTAIN CONFORMING AMENDMENTS.—The amendments made by subsection (c) and paragraphs (1) and (4) of subsection (d) shall take effect on the date of enactment of this Act.

(5) EXTENSIONS UNDER SECTION 6166A.—For purposes of applying sections 6653, 7479, and 7485 of such Code, an actual controversy involving acceleration of the time for payment under section 6166A(h) of such Code (as in effect with respect to estates of decedents dying before January 1, 1982) shall be treated as an actual controversy involving acceleration of the time for payment under section 6166(g) of such Code.

DESCRIPTION OF TAX BILLS AND OTHER ESTATE TAX MATTERS

RELATING TO

THE SECTION 6166 TECHNICAL REVISION ACT OF 1982 (S. 2479); THE TAX TREATMENT OF CERTAIN DISCLAIMERS (S. 1983); AND THE ESTATE TAX VALUATION OF CERTAIN MINERAL PROPERTY

PREPARED BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on May 27, 1982, regarding estate and gift taxes.

There are two bills and one other matter scheduled for the hearing: S. 2479 (Senators Symms, Bentsen, Boren, Grassley, et. al.), relating to the installment payment of estate tax attibutable to certain interests in closely held businesses; S. 1983 (Senators Symms and Wallop), relating to the tax treatment of certain disclaimers; and the estate tax valuation of certain mineral property.

The first part of the pamphlet is a summary of the bills and the other matter. This is followed by a more detailed description of the bills, including present law, issues, explanation of the provisions of the bills, effective dates, and estimated revenue effects. This is then followed by a description of the other estate tax matter, including an explanation of present law.

I. SUMMARY

1. S. 2479—Senators Symms, Bentsen, Boren, Grassley, Helms, Jepsen, Johnston, Mathias, Mattingly, McClure Nunn, and Zorinsky

"Section 6166 Technical Revision Act of 1982"

In general, estate tax must be paid within 9 months after a decedent's death. However, if certain requirements are satisfied and the executor makes an election, payment of estate tax attributable to certain interests in closely held businesses can be extended and paid in installments over 14 years (interest for 4 years followed by from 2 to 10 payments of principal and interest) (sec. 6166). A special 4-percent interest rate is provided for tax attributable to the first $1 million in value of the closely held business interest (sec. 6601(j)). Tax in excess of this amount ($345,800 of tax less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (sec. 6601(a)). The regular deficiency rate currently is 20 percent.

The bill would expand the types of interests in partnerships and corporations that are eligible for special treatment under the installment payment provision and would also permit the installment payment of estate tax attributable to certain combinations of assets that do not comprise an active business operation.

Under the bill, heirs would be permitted to dispose of interests in closely held businesses and to withdraw funds from the businesses for more purposes than is permitted under present law without losing the benefit of the 14-year extension of time for payment of tax.

The bill would also permit an estate tax deduction, in advance of payment, for interest that it is estimated will accrue on deferred tax during the 14-year extension period, and would provide a new interest rate applicable to the portion of deferred tax not subject to the special 4-percent rate of present law.

Finally, a new declaratory judgment provision would be enacted to provide Tax Court review of Internal Revenue Service determinations regarding eligibility for the installment payment provision and acceleration of unpaid tax. The decision of the Tax Court in these matters would be reviewable in the same manner as other decisions of that court.

2. S. 1983—Senators Symms and Wallop

Tax Treatment of Certain Disclaimers

A disclaimer is an irrevocable and unqualified refusal to accept an interest in property. If a disclaimer is qualified for Federal tax purposes, the Federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Under present law (applicable to transfers occurring after December 31, 1976), a disclaimer is effective for Federal transfer tax purposes if the requirements of Code section 2518 are satisfied. One of these requirements is that the disclaimer must be made not later than nine months after the date on which the transfer creating the interest occurs. In the case of a transfer of a remainder interest, the section provides that the remainder interest must be disclaimed within nine months of the transfer creating the interest.

Prior to the enactment of section 2518, however, there was no uniform Federal law regulating the manner or timing of disclaimers. In regulations promulgated on November 14, 1958, the Internal Revenue Service took the position that, in order for a disclaimer to be effective for estate and gift tax purposes, the disclaimer had to be effective under local law and that it had to be made within a reasonable time after knowledge of the existence of the transfer. Thus, an individual wishing to disclaim a remainder interest was required to do so within a reasonable time after he obtained knowledge of the creation of the remainder interest rather than with a reasonable time after the death of the life tenant. The 1958 regulations applied to all transfers regardless of whether the transfer occurred prior to the promulgation of the regulations. Thus, an individual wishing to disclaim a remainder interest created prior to 1958 would have had to disclaimed the remainder interest within a reasonable time after that individual obtained knowledge of the creation of the remainder interest. On February 23, 1982, the Supreme Court upheld the Internal Revenue Service regulations with regard to the disclaimer of a remainder interest created prior to 1958. *Jewett* v. *Commissioner*, 50 U.S.L.W. 4215 (1982).

The bill would permit individuals possessing interests created by transfers prior to November 15, 1958, to disclaim those interests within (a) nine months after the date of enactment of the bill, or (b) nine months of the first day the disclaimant had knowledge of the disclaimed interest (which knowledge must be established by clear and convincing evidence), but in no event later than December 31, 1991.

3. Estate Tax Valuation of Certain Mineral Property

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use.

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. However, in all cases, it is presumed that land would change hands between a willing buyer and a willing seller based on the "highest and best use" to which that land could be put, rather than the actual use of the land at the time it is transferred.

Under present law, there are no special provisions regarding the valuation of mineral interests. However, to properly value real property at its highest and best use, the value of any underlying mineral interests must be considered, whether or not those mineral interests are presently being exploited. The issue is whether it is appropriate to determine the fair market value of real property by including the potential value of any undeveloped mineral rights.

II. DESCRIPTION OF THE BILLS AND OTHER ESTATE TAX MATTERS

1. S. 2479—Senators Symms, Bentsen, Boren, Grassley, Helms, Jepsen, Johnston, Mathias, Mattingly, McClure, Nunn, and Zorinsky

"Section 6166 Technical Revision Act of 1982"

Present Law

Overview

In general, estate tax must be paid within 9 months after a decedent's death. However, if certain requirements are satisfied and the executor makes an election,[1] payment of estate tax attributable to certain interests in closely held businesses can be extended and paid in installments over 14 years (interest for 4 years followed by from 2 to 10 annual payments of principal and interest) (sec. 6166).[2] A special 4-percent interest rate is provided for tax attributable to the first $1 million in value of the closely held business interest (sec. 6601(j)).[3] Tax in excess of this amount ($345,800 currently is less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (sec. 6601(a)). The regular deficiency rate currently is 20 percent.

Qualification requirements

To qualify for the installment payment provision, at least 35 percent of the value of the decedent's adjusted gross estate must consist of the value (net of business indebtedness) of an interest in a closely held business. Under section 6166, all proprietorships owned by the decedent qualify as an interest in a closely held business. In addition, an interest in a closely held business includes interests in partnerships and corporations if certain "percentage tests" or "numerical tests" are satisfied. An interest of a partner in a partnership carrying on a trade or business qualifies if—

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[1] The election must be made within 9 months after the decedent's death (15 months if an extension of time to file the decedent's estate tax return is granted) (sec. 6166(d)). If a deficiency is later assessed, the deficiency is prorated among the installment payments to the extent that it would have been eligible for extended payment had the amount been shown on the estate tax return and if the deficiency was not due to negligence or intentional disregard of rules and regulations (sec. 6166(e)). Additionally, a special election is available to pay deficiency amounts in installments where (1) no installment payment election was initially made, (2) the estate, after examination, meets all requirements of the provision, and (3) the deficiency was not due to negligence or intentional disregard of rules and regulations (sec. 6166(h)).

[2] Because eligibility for the installment payment provision relates to the time of payment rather than the amount of tax, the decision of the Internal Revenue Service as to an estate's eligibility or as to acceleration of unpaid tax is not subject to judicial review.

[3] While the installment payment provision is generally explained as deferring estate tax attributable to closely held business property, that is not always true. The estate may extend payment of a percentage of its tax equal to the percentage of the adjusted gross estate which the business property comprises. This extension is available even if the inclusion of the business property does not result in any additional estate tax— as, for example, where it passes tax-free to a surviving spouse pursuant to the marital deduction.

(a) 20 percent or more of the value of the total capital interest in the partnership is included in the value of the decedent's gross estate ("percentage test"); or

(b) the partnership has 15 or fewer partners ("numerical test").

Stock in a corporation carrying on a trade or business qualifies if—

(a) 20 percent or more in value of the voting stock in the corporation is included in the value of the decedent's gross estate ("percentage test"); or

(b) the corporation has 15 or fewer shareholders ("numerical test").[4]

Attribution rules

Present law contains rules under which property owned by certain other persons is treated as owned by the decedent for purposes of determining whether the decedent's interest was an interest in a closely held business ("attribution rules"). These attribution rules are of two types—automatic and elective. Under these attribution rules, stock and partnership interests held by a husband and wife as community property or as joint tenants, tenants by the entirety, or tenants in common, are treated as owned by the decedent in determining the number of shareholders or partners a corporation or a partnership has. Additionally, all stock and partnership interests owned by members of the decedent's family[5] are treated as owned by the decedent. To prevent the use of trusts, corporations, and partnerships to avoid the numerical qualification tests for corporations and partnerships, the installment payment provision provides that property owned directly or indirectly by a corporation, partnership, estate, or trust is treated as owned proportionately by the owners of the entity.

The elective attribution rules permit an executor to elect to treat capital interests in partnerships and non-readily-tradable stock[6] owned by members of the decedent's family as owned by the decedent to determine whether the decedent owned 20 percent or more of voting stock or partnership capital in the closely held business (i.e., satisfied the percentage tests). If the elective attribution rules are used to qualify a business interest for the installment payment provision, the estate is not entitled to the special 4-percent interest rate or the initial 5-year deferral period for principal.

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[4] In the case of proprietorships, Treasury regulations provide that only assets actually used in the business are considered for purposes of the "35 percent of adjusted gross estate" test. In the case of partnerships and corporations, on the other hand, all partnership and corporate assets are considered even where some of the assets are not actually used in the business operation (Treas. Reg. § 20.6166A-2(c)).

[5] Family members include an individual's brothers and sisters, spouse, ancestors, and lineal descendants (sec. 267(c)(4)).

[6] Non-readily-tradable stock is stock for which there was no market on a stock exchange or over-the-counter market at the time of the decedent's death.

Aggregation rules

Present law also permits "aggregation" of interests in multiple closely held businesses to qualify an estate for the installment payment provision if 20 percent or more of the total value of each aggregated business is included in the value of the decedent's gross estate. Under the aggregation rules, the value of property owned by a surviving spouse with the decedent as community property, joint tenants, tenants by the entirety, or tenants in common is treated as owned by the decedent.

Definition of trade or business

Under present law, the installment payment election is available only for interests in active trades or businesses as opposed to passive investment assets. The Congressional intent that this provision not apply to all businesses or investment assets is illustrated by the Report of the Committee on Ways and Means on the Small Business Tax Revision Act of 1958 (H. Rept. No. 2198),[7] where the committee stated,

> The bill is to aid and encourage small business. It is not, however, an attempt to settle all of the small-businesses problems, even in the area of Federal taxation.
>
> * * *
>
> The . . . goal of the bill is to prevent the breakup of small businesses once they are established, and to prevent their consolidation into larger businesses. To aid in this respect your committee has provided up to 10 years for payment of estate taxes where investments are in a closely held business. This should make it unnecessary to sell a decedent's business in order to finance his estate tax.

The determination of whether an interest in an active trade or business is present is factual and must be made on an case-by-case basis. In interpreting the legislative history of the provision, the Internal Revenue Service takes the position that a passive holding company is [illegible] carrying on a trade or business. Further, the Service takes the position that the holding company is not pierced to determine whether any subsidiary owned in part or in whole by it is carrying on a trade or business. Likewise, the Service takes the position that assets passively leased to a separate active business, in which the decedent also owns an interest, do not constitute a trade or business for purposes of the installment payment provision.

The most detailed guidelines on what constitutes a trade or business under the installment payment provision are found in three 1975 revenue rulings—Rev. Rul. 75-365, 1975-2 C.B. 471; Rev. Rul. 75-366, 1975-2 C.B. 472; and Rev. Rul. 75-367, 1975-2 C.B. 472—issued under former section 6166A.[8]

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[7] The Small Business Tax Revision Act was enacted as Title II of the Technical Amendments Act of 1958 (P.L. 85-866, approved September 2, 1958). That Act included the predecessor provision to the present installment payment provision.

[8] Section 6166A, designated section 6166 before 1977, provided for payment of estate tax attributable to interests in closely held businesses in from 2 to 10 annual installments. Section 6166A was repealed by the Economic Recovery Tax Act of 1981, effective for estates of individuals dying after December 31, 1981.

In Rev. Rul. 75–365, *supra*, the IRS ruled that rental commercial property, rental farm property, and notes receivable did not constitute a trade or business within the meaning of the installment payment provision. The Service stated that the determination of what constitutes a trade or business is not made merely by reference to a broad definition of business or by reference to case law under section 162. It noted that——

> Although the management of real property by the owner may, for some purposes, be considered the conduct of business in the case of a sole proprietorship [the installment payment provision applies] only with respect to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets.
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> * * *
>
> It follows that the mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute. (*Id.*).

Rev. Rul. 75–366, *supra*, applied the trade or business testin a farming situation. In that case, the decedent leased real property to a tenant on a crop share basis. In addition to sharing in the farm expenses and production, the decedent actively participated in important management decisions. The decedent was held to be in the business of farming under these facts, the Service saying——

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit. either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.
>
> In the present case the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.
>
> Accordingly, the farm real estate included in the decedent's estate qualifies . . . as an interest in a closely held business. (*Id.*).

Finally, Rev. Rul. 75–367, *supra*, held that a subchapter S corporation engaged in home construction was a trade or business within the meaning of the installment payment provision, but ownership and management of eight rental homes was not. The ruling also held that a proprietorship that developed land and sold new homes built by the construction company was a trade or business. In that ruling, the Service construed Congressional intent in enacting the installment payment provision as being to permit——

> * * * [T]he deferral of the payment of the Federal estate tax where, in order to pay the tax, it would be necessary to sell assets used in a going business and thus disrupt or destroy the business enterprise. Thus [provision] was not intended to protect continued management of income producing properties or to permit deferral of the tax merely because the payment of the tax might make necessary the sale of income-producing assets, except where

they formed a part of an active enterprise producing business income rather than income solely from the ownership of property. (*Id.* at 473).

When interests in oil and gas ventures constitute a trade or business within the meaning of the installment payment provision was the subject of a separate ruling by the IRS. In Rev. Rul. 61-55, 1961-1 C.B. 713, the Service held that the ownership, exploration, development, and operation of oil and gas properties is a trade or business, but the mere ownership of royalty interests is not.[9]

Acceleration of unpaid tax

The right to defer payment of estate tax is terminated upon the occurrence of certain events during the 14-year extension period. If such a termination occurs, all unpaid installments of tax and accrued interest are accelerated and are payable on notice and demand from the IRS.

Disposition of interest and withdrawal of funds from the business

If the persons receiving property from the decedent whose estate elects the installment payment provision make cumulative dispositions of the interest in the business and withdrawals from the business totaling 50 percent or more of the value of the decedent's interests, all unpaid installments and interest are accelerated. Generally, mere changes in form of ownership are not treated as dispositions.[10] Additionally, ERTA provided a new exception which excludes dispositions by reason of death of the heir (or a subsequent transferee) from this rule. However, this exception applies only if the property is transferred to a member of the deceased heir's (or subsequent transferee's) family.

A further exception is provided for withdrawals from a corporation pursuant to a redemption under section 303, but only if all proceeds of the redemption are used to pay Federal estate taxes no later than the due date of the first installment becoming due after the redemption (or one year after the redemption, if earlier).[11]

Undistributed income of estate

If an estate has undistributed net income in any year, the income must be applied against unpaid installments by the due date of the estate's income tax return, or the unpaid tax and accrued interest is accelerated.

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[9] Under present income tax law, co-ownership of working interests in an oil and gas lease is treated as a partnership; however, if the co-owners elect, they will be treated as proprietors rather than partners (sec. 761(a)). This "election-out" of partnership treatment is not available for estate tax purposes.

[10] Under present law, a corporate reorganization which is not an income taxable event under sec. 368(a)(1)(D), (E), or (F) is not treated as a disposition of an interest in the business for purposes of accelerating unpaid installments of tax. Likewise, certain dispositions of stock in controlled corporations (sec. 355) are not treated as dispositions.

[11] Sec. 303 provides special tax treatment for redemptions of corporate stock to the extent that the redemption proceeds to a shareholder do not exceed the total death taxes (including, but not limited to, Federal estate taxes) imposed by reason of the decedent shareholder's death and the amount of funeral and administration expenses allowable as an estate tax deduction to the estate.

Late payments of principal or interest

In general, if an estate fails to make any payment of principal or interest by its due date, all unpaid amounts are accelerated. A limited exception is provided for late payments received within six months after the due date. However, such late payments are not eligible for the special 4-percent interest rate, and the estate must pay a special penalty of 5 percent of the payment for each month (or part thereof) that the payment is late.

Deductibility of interest

Interest accrued as a result of extending payment of tax under the installment payment provision is deductible by the estate. The interest may be claimed as an administration expense in determining estate tax (sec. 2053) or may be claimed as an income tax deduction. The executor must elect the manner in which the deduction is to be claimed (sec. 642(g)).

In general, interest is only deductible for estate tax purposes when it is actually paid. The IRS holds that this general rule applies also to interest on tax payment of which is extended under the installment payment provision (Rev. Rul. 80-250, 1980-2 C.B. 278). Therefore, if an estate elects to claim such interest as an estate tax deduction, an amended estate tax return must be filed each year as the interest is paid. The interest deduction reduces the decedent's estate tax, and this reduction is reflected in reductions in the unpaid installments (Rev. Proc. 81-27, 1981-27 I.R.B. 21).

Other extensions of time to pay estate tax

If an estate is not eligible to defer estate tax under the installment payment provision, payment of the tax may be extended under the general estate tax extension of time to pay. Present law permits an extension of time to pay tax for up to 10 years upon a showing of reasonable cause. This extension is granted for a maximum period of one year at a time and can be renewed annually (as long as the reasonable cause continues to exist). One situation in which reasonable cause is present is where an estate does not have sufficient funds to pay the tax when otherwise due without borrowing at a rate of interest higher than that generally available (Treas. Reg. § 20.6161-1(a)).

Issues

The principal issue is whether the installment payment provision should be expanded to allow estate tax attributable to additional types of business investments.

A second issue is whether the circumstances under which estate tax deferred under the installment payment provision is accelerated should be liberalized.

A third issue is whether the normal rule that interest is deductible for estate tax purposes only when paid should be changed in the case of interest accruing on estate tax deferred under this provision so as to permit a deduction for the full amount of interest which might be paid when the estate tax return is filed.

A fourth issue is whether an interest rate, other than the regular deficiency rate, should apply to extended amounts of tax in excess of amounts subject to the special 4-percent rate of present law.

A final issue is whether decisions of the Internal Revenue Service as to qualification of an estate for the installment payment provision or acceleration of unpaid tax should be subject to judicial review even though the amount is not in dispute.

Explanation of the Bill

Overview

The bill would expand the types of assets that are eligible for special treatment under the installment payment provision as an interest in a closely held business in several ways, would liberalize the rules under which unpaid installments of tax and interest are accelerated, would provide a new interest rate on deferred tax and new rules on the deductibility of that interest, and would provide for judicial review of IRS determinations under the provision.

Qualification requirements

General rules

The bill would expand the types of business interests that qualify for the installment payment provision in numerous ways. The bill would increase the number of partners or shareholders a closely held business can have under the numerical tests for qualifying interests in a partnership or corporation as an interest in a closely held business from 15 to 35. Thus, under the bill, if a partnership or corporation had 35 or fewer partners or shareholders, the numerical test would be satisfied.

The bill would count interests in partnership profits under the percentage test for qualifying interests in a partnership as an interest in a closely held business. Only interests in partnership capital are counted under present law. Thus, under the amendment, if the decedent owned capital or profits interests in a partnership, or a combination of the two, totaling 20 percent or more of the value of the business, the percentage test would be satisfied.

The bill would count nonvoting stock under the percentage test for qualifying an interest in a corporation as an interest in a closely held business. Only voting stock is counted under present law. Thus, under the bill, if the decedent owned voting or nonvoting stock, or a combination of the two, totaling 20 percent or more of the value of the business, the percentage test for corporations would be satisfied.

The bill would treat certain notes and other evidences of indebtedness as interests in closely held businesses (in addition to stock and partnership interests which are considered under present law) in determining whether the decedent owned an interest in a closely held business. This type of interest would be considered in addition to, or in combination with, corporate stock or interests in partnership profits and capital. Only debt interests acquired in exchange for stock and partnership interests owned by the decedent or for money which the decedent loaned the business more than one year before his death, would be considered. Thus, under the bill, the fact that the decedent withdrew from the business by selling the decedent's interest pursuant to a "buy-out" agreement with another owner who planned to continue the business after withdrawal from the business of the decedent would not preclude availability of the installment payment provision for the decedent's estate.

The bill would eliminate the present law difference in treatment of certain nonbusiness assets owned by partnerships and corporations as compared to those assets owned by individuals carrying on businesses as proprietorships. The bill would apply the present rule for proprietorships to all businesses where assets were contributed to the business by or on behalf of the decedent and were not used in the conduct of the business throughout the one-year period ending on the date of the decedent's death. Therefore, under the bill, these nonbusiness assets would not be included in determining whether the decedent's interest in the business satisfied the requirement that 20 percent or more of the total interests in a partnership or 20 percent or more of the stock in a corporation (i.e., the percentage tests) be included in the decedent's gross estate.

Attribution rules

The bill would combine the automatic and elective attribution rules of present law and would eliminate the penalties that apply under the elective attribution rules. The new attribution rules would apply to both the numerical tests and percentage tests for determining whether partnerships and corporations are closely held businesses. In addition, the definition of family member (i.e., persons whose stock or partnership interests are treated as owned by the decedent) would be expanded to include spouses of brothers, sisters, and lineal descendants of the decedent as well as estates of family members. The broader attribution rules would normally increase the value of the business interest treated as owned by the decedent for purposes of determining whether his estate qualified under the installment payment provision.

Aggregation rules

The bill would expand the present law rules under which interests in multiple businesses are aggregated to qualify for the installment payment provision. Under the bill, interests which satisfy either the numerical test or the percentage test for determining whether the business is a closely held business could be aggregated to meet the requirement that an interest in a closely held business equal at least 35 percent of the decedent's adjusted gross estate. This aggregation would only be permitted if the value of each such business comprised a least 5 percent of the value of the decedent's adjusted gross estate. Thus, an estate could aggregate interests in a maximum of 20 businesses to qualify for the installment payment provision.

Definition of trade or business

The bill would expand the types of assets that, in combination, constitute a trade or business under the installment payment provision to include interests (stock, partnership interests, and indebtedness) in passive holding companies to the extent that the holding company assets represent interests in active businesses which would meet the requirements of the provision if owned directly.

The bill would also expand the availability of the installment payment provision for estates owning interests in oil and gas ventures. Under the bill, if an income tax election to treat co-owners of an oil and gas lease as proprietors were in effect at the decedent's death (under sec. 761(a)), the co-owners would be treated as proprietors for estate tax purposes as well.

Two other exceptions to the active business requirement would be enacted by the bill. First, the bill would treat royalty interests in oil and gas ventures as interests in closely held businesses regardless of whether these interests are essentially passive investment assets. Second, the bill would treat assets owned by the decedent that are passively leased to a closely held business in which the decedent was a partner or shareholder as interests in such a business.

Expansion of acceleration exceptions

The bill would expand the present law situations in which an interest in a closely held business can be disposed of and in which property can be withdrawn from the business during the extended payment period without accelerating the payment of deferred estate tax. These expanded exceptions would apply to estates of individuals who died before 1982 which elected the benefits of former section 6166A as well as to all estate electing the present installment payment provision.

Dispositions and withdrawals to pay death taxes and estate expenses

The present rule under which certain redemptions of stock from a corporation solely to pay Federal estate taxes are not treated as dispositions or withdrawals under the acceleration rules would be amended to extend this rule to any disposition or withdrawal of funds of an interest in a closely held business (whether or not by means of a redemption under sec. 303) to the extent that the proceeds are used to pay any death taxes resulting from the decedent's death (including, but not limited to, Federal estate taxes) and also funeral and administration expenses (including interest on the deferred tax) allowable to the estate as an estate tax deduction. Thus, the exception would apply to proprietorships and partnerships as well as corporations and would permit interests in the business to be sold to third parties as well as redeemed by the business entity. In addition, the bill would delay the date by which the tax would have to be paid following the disposition in the case of dispositions occurring during the first 5 years of the extended payment period. In such cases, payment of the taxes or expenses would not have to be made until the due date of the first installment of tax. Therefore, estates could dispose of stock in a closely held business up to 5 years before the proceeds of the disposition were used for payment of death taxes or funeral or administration expenses.

Reorganizations

The bill would expand the present exception to the acceleration rules for certain corporate reorganizations and stock distributions to include additional types of reorganizations (under sec. 368(a)(1)) and also tax-free exchanges of common stock for preferred stock in the same corporation (under sec. 1036).

No acceleration on subsequent death

The bill would expand the present exception to the acceleration rules for dispositions to a family member by reason of death of the heir (or subsequent transferee) receiving the decedent's closely held business property, to permit such transfers without acceleration of unpaid tax whether or not the transferee is a family member.

No acceleration in case of certain buy-outs

The bill would enact a new exception to the acceleration rules for certain dispositions of interests in and withdrawals of funds from closely held partnerships and corporations if a note, rather than cash, is received. Under the new exception, the heir receiving the decedent's closely held business interest would be treated as disposing of the interest only to the extent that the value of the surrendered stock or partnership interest exceeded the face value of the note. The exception would only be available for exchanges where the note is (1) given by the corporation or partnership, or (2) where the note is given by another shareholder, partner, or an employee, and the purchaser had been a shareholder, partner, or employee of the business at all times during the one-year before the exchange. If the purchaser were a shareholder or employee, the corporation or partnership would be required to guarantee the note. The bill would include special rules to accelerate unpaid tax if the note became readily tradable, were surrendered, or if 50 percent or more of the value of the business were acquired by a corporation whose stock was readily tradable.[12]

Involuntary conversions

The bill would provide that, in the case of an involuntary conversion, an interest in closely held business property is not considered to be disposed of to the extent that qualified replacement property is acquired.

Like-kind exchange

The bill would provide that, in the case of a like-kind exchange, an interest in closely held business property is not considered to be disposed of to the extent that the exchange is not taxable for income tax purposes (under sec. 1031).

Interest on installment payments

Under the bill, the special 4-percent interest rate would continue to apply the first $345,800 (minus the amount of the decedent's unified credit) of estate tax extended under the installment payment provision. However, the rate on extended amounts in excess of the amount subject to the 4-percent interest rate would not accrue interest at the rate otherwise applicable to deficiencies (currently 20 percent). Under the bill, extended amounts in excess of this 4-percent portion would accrue interest at a rate equal to the average yield to maturity, of 14-year United States obligations, during the month of December preceding the year of the decedents' death.[13]

The bill would also change the manner in which the interest on installment payments is deducted for estate tax purposes. Under the bill, the full amount of interest anticipated to be paid over the 14-year extended payment period would be deductible when the decedent's estate tax return was filed (even though the interest was not paid at that time). The amount of this deduction would not be discounted to reflect the fact that the interest was not presently payable. If the installment payment election were terminated before expiration of the 14-year extension period, the estate would recompute the deduction for interest, and its estate tax, at the time of the termination.

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[12] Readily tradable stock or notes would be stock or notes which there was a market in any stock exchange or in any over-the-counter market.

[13] At the present time, the Treasury Department has no obligations maturing in the month of December. Long-term obligations are normally issued in January with maturity dates of February 15, May 15, August 15, or November 15.

Declaratory judgment relating to installment payment provision

The bill would provide a precedure for obtaining a declaratory judgment with respect to—

(1) an estate's eligibility for extension of tax under the installment payment provision, or

(2) whether there is an acceleration of unpaid tax.

The declaratory judgment provision would only be available when there is an actual controversy; therefore, no declaratory judgment would be available before the decedent's death (with respect to eligibility for the extension) or before a transaction causing a potential acceleration of unpaid tax.

Jurisdiction to issue the declaratory judgment would be in the Tax Court, and the decision of the Tax Court would be reviewable in the same manner as other decisions. Collection of tax would be stayed until after a decision was rendered by the Tax Court, but the executor (or heir in the case of a dispute over acceleration of unpaid tax) would be required to pay the tax or post bond before appealing from the Tax Court. The bill would also permit the courts to impose penalties in the case of actions brought primarily for delay and where it was determined that the estate was not eligible for the extension provided by the installment payment provision or that the tax was properly accelerated.

Effective Dates

The provisions of the bill would apply generally to estates of individuals dying after December 31, 1981.

The provisions of the bill relating to acceleration of unpaid tax would apply to dispositions and withdrawals after December 31, 1981.

The provisions of the bill amending the rate of interest charged on installment payments and the estate tax deductibility thereof would apply to estates of individuals dying after December 31, 1981, and also—

(1) in the case of the rate of interest charged on installment payments, to tax outstanding on January 1, 1982, for an estate for which a timely election was made under either section 6166 or section 6166A, if the executor elects to have the amendment apply; and

(2) in the case of the rules on the estate tax deduction of interest on installment payments, to tax estimated to accrue after December 31, 1981, for an estate for which a timely election was made under either section 6166 or section 6166A, if the executor elects to have the amendment apply.

Elections to have these amendments apply could be made even though the estate had elected previously to claim the interest as an income tax deduction.

The provisions of the bill authorizing penalties in the case of certain declaratory judgment proceedings, and appeals from Tax Court decisions, would apply after the date of enactment.

Revenue Effect

It is estimated that this bill would reduce Federal budget receipts by less than $50 million in fiscal year 1982, by $476 million in fiscal 1983, by $514 million in 1984, by $555 million in 1985 and by $599 million in 1986.

2. S. 1983—Senators Symms and Wallop

Tax Treatment of Certain Disclaimers

Present Law

In general, a disclaimer is a refusal to accept the ownership of property or rights with respect to property. If a qualified disclaimer is made, the Federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Prior to the enactment of section 2518 in 1976, there were no uniform Federal disclaimer rules. Before the promulgation of regulations in 1958, the administrative practice of the Internal Revenue Service was to allow the Federal tax consequences of a disclaimer to depend upon its treatment under local law.

On November 14, 1958, the Treasury Department issued regulations (T.D. 6334) which required that a disclaimer (1) be effective under local law and (2) notwithstanding the timeliness of the disclaimer under local law, be made "within a reasonable time after knowledge of the existence of the transfer." In litigating this issue, they interpreted these regulations to require that a disclaimer be made within a reasonable time after the creation of the interest, rather than the time at which the interest vested, or became possessory. Thus, for example, where property is transferred to X for life, remainder to Y, both X and Y were required to disclaim within a reasonable time of the original transfer, although Y could not take possession of the property until X's death.

These regulations also applied to interests created by transfers made prior to November 15, 1958. Thus, under the regulations, a disclaimer of an interest created by a transfer made prior to November 15, 1958, would be qualified for Federal tax purposes only if it were made within a reasonable time after the original transfer creating the interest.

This dispute as to the timing of a qualified disclaimer generated considerable litigation, with conflicting results. The Tax Court upheld the Treasury position in a series of cases including *Jewett* v. *Commissioner* 70 T.C. 430 (1978), *Estate of Halbach* v. *Commissioner* 71 T.C. 141 (1978) and *Cottrell* v. *Commissioner* 72 T.C. 489 (1979). However, the Circuit Courts were divided on the issue. The Eighth Circuit rejected Treasury's position, concluding that State law determines the validity of a disclaimer in *Keinath* v. *Commissioner* 480 F.2d 57 (1973) and *Cottrell* v. *Commissioner*, 628 F.2d 1127 (1980). However, the Ninth Circuit upheld the decision in *Jewett* v. *Commissioner* in 1980 (638 F.2d 93) and the Supreme Court granted Certiorari.

On February 23, 1982, the Supreme Court resolved the controversy in *Jewett* v. *Commissioner*[1] by upholding the Treasury position. Noting that the Treasury interpretation is entitled to respect because it has been consistently applied over the years, the Court concluded that the relevant "transfer" occurs when the interest is created and not at such later time as the interest vests or becomes possessory.

In the Tax Reform Act of 1976, Congress adopted a set of uniform rules to govern disclaimers of property interests transferred before December 31, 1976 (Sec. 2518). Under that section, a disclaimer generally is effective for Federal estate and gift tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and meets four other conditions. First, the refusal must be in writing. Second, the written refusal generally must be received by the person transferring the interest, or the transferor's legal representative, no later than nine months after the transfer creating the interest.[2] Third, the disclaiming person must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass to a person other than the person making the disclaimer or to the decedent's surviving spouse as a result of the refusal to accept the interest.[3]

Issue

The issue is whether a disclaimer by an individual of an interest created before November 15, 1958, should be effective for estate and gift tax purposes where the disclaimer is made subsequent to a reasonable period after that individual obtained knowledge of the creation of the interest.

Explanation of the Bill

Under the bill, a disclaimer of an interest created by a transfer made before November 15, 1958 would be treated as a qualified disclaimer if it meets the requirements of section 2518 and is made (1) within nine months of enactment, or (2) within nine months of the first day the disclaimant had knowledge of such interest (which knowledge must be established by clear and convincing evidence). However, in no event would a disclaimer made after December 31, 1991 be treated as a qualified disclaimer.

Effective Date

The bill would apply to disclaimers made with respect to transfers made before November 15, 1958.

Revenue Effect

It is estimated that this bill would reduce budget receipts by less than $5 million annually.

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[1] 82-1 USTC ¶13, 453; 50 U.S.L.W. 4215; 49 AFTR 2d 148,104.

[2] However, the period for making the disclaimer is not to expire until nine months after the date on which the person making the disclaimer has attained age 21.

[3] In addition, with respect to interests created after December 31, 1981, certain transfers to the person or persons who would have otherwise received the property if an effective disclaimer had been made under local law, may be treated as qualified disclaimers, provided the transfer is timely made and the transferor has not accepted the interest or any of its benefits.

3. Estate Tax Valuation of Certain Mineral Property

Present Law

Overview

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use.

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. One of the most important factors used in determining fair market value is the highest and best use to which the property can be put.

Where the fair market value of real property is the subject of dispute, there are several valuation techniques which the courts tend to accept. These methods include the income-capitalization technique, the reproduction-cost minus depreciation technique, and the comparative sales technique. Courts will generally use one of these methods, or a combination of these methods, in determining fair market value.

However, in all cases, it is presumed that land would change hands between a willing buyer and a willing seller based on the "highest and best use" to which that land could be put, rather than the actual use of the land at the time it is transferred.

Mineral interests

Under present law, there are no special provisions regarding the valuation of mineral interests. However, to properly value real property at its highest and best use, the value of any underlying mineral interests must be considered whether or not those mineral interests are presently being exploited.

If the mineral rights are being exploited, their value—in the form of a separate royalty interest—may be readily ascertainable through the expert testimony of geologists or mining engineers. Generally, such value would be based on the facts and circumstances of the particular property. Factors to be considered include: the annual income from the royalty, the amounts of any bonus payments or delay rentals received, the amount of minerals still available for exploitation and the quality of those minerals, changing market conditions affecting pricing, contractual limitations imposed on the terms and conditions of the royalty, and any government or industrial restrictions on development. The total value of the real property would include the value of these mineral rights.

If the mineral interests are not presently being exploited, valuation becomes more difficult because any determination of the property's fair market value must be made without regard to actual royalty income or development experience. Expert testimony is needed to analyze known geologic data and determine the extent and quality of any underlying mineral interest. The valuation of such interest may then be determined by analyzing comparable properties, which are presently being developed.

The determination of whether property is comparable must be made on a case-by-case basis, with no single factor being conclusive. Different parcels of real property need not be exactly alike to be comparable, however. Comparability requires only that the different parcels contain similar mineral interests.

If comparable properties are not available, the property would generally be valued through an income capitalization technique, which uses projected net income to determine the value of the underlying property. The accuracy of those projections depends, in large part, on the extent and quality of available geologic data. Where such data is incomplete, projected earnings are often discounted to offset a high degree of speculation and insure that the value of the property bears a reasonable relationship to its earning capacity.

Issues

The issues are whether it is appropriate to determine the value of real property by including undeveloped mineral rights in computing its "highest and best use" or whether it would be appropriate to exclude such value until or unless the mineral rights actually are exploited.

STATEMENT OF SENATOR DOLE

Mr. Chairman, today's hearing focuses on a number of issues in the estate tax area that merit our attention, and this is a good opportunity to start focusing on them. Unfortunately, the Treasury Department is unable to be with us this afternoon to comment on these proposals. However, I understand that they are preparing a written statement and will submit their comments to the Subcommittee in the near future.

I appreciate the effort you have made, Mr. Chairman, to secure a comprehensive revision of section 6166 through your bill, S. 2479. Section 6166 is extremely important to closely held businesses in helping them meet their estate tax obligations without being devastated by the sudden imposition of a large tax burden. Several revisions were made last year in ERTA that simplified the law, expanded the availability of the installment payment method with respect to interests in a closely held business, and further limited the cases where acceleration of payment is required. These changes were by and large helpful.

I doubt that anyone would disagree that further modifications in section 6166 are needed, and there are a number of provisions of S. 2479 on which we could no doubt reach quick agreement. In fact, the provision for a declaratory judgment proceeding to facilitate review of I.R.S. determinations on eligibility for installment payment or on the need for acceleration of payment, is already an issue in conference with the House on H.R. 4717. Perhaps we can take care of this one matter in that context.

There are, however, some aspects of this legislation that may be cause for concern and that will merit careful review. The Joint Committee on Taxation estimates that the entire package on changes included in S. 2479 would cost on the order of $600 million in lost revenues when fully implemented. Given our fiscal situation, it may be necessary to find some way to reduce that cost by choosing among the most important provisions of the package. After all, however good our intentions, we cannot do everything all at once.

Another issue that merits review include, the appropriateness of allowing full upfront deductibility of interest as an administration expense without some modification of the rate of interest charged. As drafted, the bill would substitute an interest rate tied to 14-year U.S. obligations for the normal 20 percent rate currently applicable to deficiencies. If we are going to provide relief with regard to deductibility of interest at the outset, we should consider carefully whether this additional relief is also justified.

I would also note that the proposal to allow aggregation of interests in multiple businesses is something that ought to be carefully examined, as is the suggested treatment of certain royalty interests as an exception to the active business requirement. There are many good things in this bill, and I do not want to be negative: but the bill does raise a number of serious issues concerning the fundamental purposes of Section 6166, and I think we all understand that these issues will have to receive close consideration.

S. 1983

The Second bill being reviewed this afternoon, S. 1983, deals with an equitable question that has been brought to my attention before. Basically, the question is whether an appropriate time period can be set to allow disclaimers of interests created before November 15, 1958, with creating too broad an exception from the current law governing disclaimers. Hopefully some accommodation could be reached to cover those who were caught when the I.R.S. revised its policy in 1958.

I look foward to reviewing the testimony scheduled for this afternoon.

Senator SYMMS. The committee will come to order—the Committee on Finance Subcommittee on Estate and Gift Taxation.

First, I want to welcome all of you who are here to testify this afternoon. The first item on the agenda is S. 2479, legislation which corrects technical deficiencies in section 6166 and the redemption rules under section 303.

A task force on technical revision of section 6166 was formed last year in an effort to clean up this particular section of the code.

At this time I would like to extend my sincere appreciation for the efforts of all members of the task force. Many long hours were expended by the task force in working out a proposal which developed into a bill that has been introduced, S. 2479.

There is no question that section 6166 needed to be clarified, and I am hopeful that our efforts will not go for nought and that we will be able to pass legislation into law this year.

In 1958 when Congress first implemented section 6166 the intent of Congress was to allow illiquid closely held business interests including farms the ability to pay their estate taxes over a period of 15 years so the business or farm would not have to sell to larger corporations or foreign interests because of an immediate overly burdensome estate tax.

I believe congressional intent is still the same; however, in order for the intent of Congress to be fully implemented it is necessary to clean up this section of the code.

The second item on the agenda, S. 1983, is legislation which will remedy an existing inequity in our tax system by providing the holders of the remainder of interest created before the publication of IRS regulations in 1958 will have a period of 9 months after the enactment of this bill within which to disclaim their interest in a gift for gift tax purposes.

There is clearly a need to correct this situation, particularly for the interest created prior to the publication of the IRS regulations. If the IRS view prevails, the result is that holders of the remainder interest in trusts created prior to January 1, 1977, were and are now forever preempted from taking effective disclaimers.

Strangely, section 2518 gives the holders of the remainder interest created after January 1, 1977, those created with the full knowledge of the new law, a 9-month period in which to disclaim. It could not have been the intent of Congress to grant a 9-month period to disclaim to those interests created after the law was known and at the same time to deny those trusts already in existence the right to conform to the new standards.

Again, I am hopeful Congress will be able to correct this inequity in the near future.

The third item on our agenda today concerns an issue on which I will be introducing legislation in the near future. The legislation I intend to introduce will exclude the mineral value of land for estate tax purposes until the land or mine is actually producing revenue.

It is absolutely clear that the issue of U.S. dependency on foreign mineral resources is just as important as the issue of our dependency on foreign energy resources. The President has recognized the importance of this issue and recently submitted to Congress the national materials and minerals program plan and report.

On the first page of the report President Reagan states that the national minerals policy recognizes the critical role of minerals to our economy, national defense, and the standard of living, the vast unknown and untapped mineral wealth of America, and the need to keep the public lands open to appropriate mineral exploration and development, the critical role of government in alerting the Nation to minerals issues and into ensuring that the national decisionmakers take into account the impact of their decisions on minerals policy and the need for long-term high potential payoff re-search activity of wide generic application to improve and augment domestically available minerals.

I believe that it is in our national interest to allow a mine that is in the process of being developed to continue to be developed even if the owner unfortunately dies. I look forward to receiving testimony on this issue.

Again, I do want to pay a special note of appreciation to the members of the task force and to members of the staff on the committee, and particularly Ann Canfield of my staff, who worked very hard to get that task force coordinated and together. I think without your help we would have been unable to move this far with the legislation, as far as making some of these corrections.

The first panel on S. 2479 consists of a former member of this committee, Hon. Carl Curtis, former Senator from the State of Nebraska, with Nelson and Harding, Washington, D.C.; Mac Asbill; and Ron Abramson.

Gentlemen, I know you have worked long and hard to make these statements, and the Chair is aware of your efforts. I would certainly say that I would appreciate it if we could keep our statements, as best as possible, within the 5 minutes. We will try to move the hearings as fast as possible this afternoon.

You never can tell when you schedule one of these hearings what is going to be happening on the floor. I might just say for those who are in the room that the urgent supplemental appropriation bill is on the floor. There have been a handful of us over there who have not been favorable to some of the amendments that are on that bill, and we are presently in a holding action over on the floor.

So, it would be helpful for the chairman this afternoon if we could expedite the hearing; not that we are going to in any way not play close attention to your testimony—that I can assure you we will. But I would ask unanimous consent that all witness's entire statements be a part of our record today, and then they would be welcome, if they wish, to shorten their statements or give them in the best fashion that they feel comfortable with.

So, Senator Curtis, we welcome you to this committee as always, and we will be happy to hear from you.

STATEMENT OF HON. CARL T. CURTIS, FORMER U.S. SENATOR FROM THE STATE OF NEBRASKA

Mr. Curtis. Thank you, Mr. Chairman. I want to express our deep gratitude for the opportunity to appear. We know the time schedule is difficult. We are very grateful for this hearing.

With me today are Mr. Mac Asbill, Jr., of the firm of Sutherland, Asbill and Brennan, and Mr. Ronald Abramson of the firm of Silverstein and Mullens.

Section 6166 was enacted by the Congress in order to make it possible for more businesses to be continued by the families of the decedents rather than forcing the sale of such businesses for the payment of estate taxes.

Estate taxes are very burdensom, especially in this time of inflated values. A very modest estate can amount to $100,000 after all adjustments, deductions, and credits are taken into account. The rate of tax reaches 30 percent on the first $100,000 of the taxable estate and is graduated upward.

Section 6166 provides that in the case of an estate where the owner was the owner of an interest in a closely held business, that the estate tax may be paid in installments over a period of up to 15 years with a reduced interest rate of 4 percent on the unpaid balance.

Without section 6166, many small and medium size family businesses would have to be sold to pay the estate tax. In many situations the only likely buyers are the very large corporations. Thus, section 6166 is necessary if the decedents' families are going to continue with the business.

Today I wish to direct your attention to what is an interest in a closely held business. If a decedent owns a bank, that is ownership in a closely held business, the decedent is engaged in a trade or business. But suppose that a decedent was the owner of a holding company which in turn was the sole owner of the stock of the bank; did the decedent own an interest in a closely held business? Was the decedent engaged in a trade or business?

Based upon what clearly appears to be the intent of Congress, the answer is yes. The decedent was engaged in a trade or business because under section (b)(2)(C) it says:

> Property owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

In support of this contention, I would like to submit a brief I prepared which is in the form of a letter to Mr. Douglass W. Charnas of the Internal Revenue Service, dated March 17, 1980, to be printed at the end of my remarks.

Senator SYMMS. Without objection.

Mr. CURTIS. In my opinion Congress intended that the benefits of section 6166 should be available to families of decedents where the decedents were the real owners of the trade or business regardless of the form of the business organization in which the decedents chose to operate.

I will not take the committee's time to cite a long list of sections of the Internal Revenue Code, which has similar language on indirect ownership and where the regulations and rulings hold that if a parent corporation owns a subsidiary and the subsidiary is engaged in a trade or business that the parent corporation and the owner thereof are engaged in a trade or business.

The regulations for section 6166 have not yet been issued. We need legislation to clarify the evident intent of Congress in reference to holding companies. Two private letter rulings, 8130175 and 8134012, were issued by the IRS and set forth the principle that if a parent corporation owns a subsidiary which is engaged in trade or business, that the parent corporation is not so engaged.

Private letter rulings are not to be cited as precedents, and these letter rulings are not in accord with what the Congress intended in the writing of section 6166. But it does point out the need for the enactment of this legislation.

Mr. Chairman, I would like to call on Mr. Abramson. He will be followed by Mr. Asbill.

[The letter to Mr. Douglass Charnas follows:]

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March 17, 1980

Douglass W. Charnas, Esq.
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1111 Constitution Avenue, N. W.
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Dear Mr. Charnas:

Please refer to my letter to you dated January 25, 1980, in reference to the drafting of the regulation for Section 6166. With your permission I would like to submit a further statement which is somewhat more detailed.

Section 6166 was enacted by the Congress in order to make it possible for more businesses to be continued by the families of the decedents rather than forcing the sale of such businesses for the payment of estate taxes.

In the enactment of the original Section 6166 (now 6166A) in 1958, the Congress declared its purpose in H.R. Rep. No. 2198, 85th Congress, 2d Sess. 16 (1958):

> "The third goal of the bill is to prevent breakup of small businesses once they are established, and to prevent their consolidation into larger businesses. To aid in this respect, your committee has provided up to ten years for the payment of estate taxes where investments are in a closely held business. This should make it unnecessary to sell a decedent's business in order to finance his estate tax. P. 3."

The present Section 6166 provides for a delay up to five years in the payment of the first installment of the estate tax and then the estate tax may be paid in not to exceed ten equal installments.

The part of the section which defines "an interest in a closely held business" as it relates to the decedent's estate described herein is as follows:

> Sec. 6166(b)
>
> (b) Definitions and special rules.-
>
> (1) Interest in closely held business.-For purposes of section, the term "interest in a closely held business" means-
>
> **********
>
> (C) Stock in a corporation carrying on a trade or business if-
>
> (i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or
>
> (ii) such corporation had 15 or fewer shareholders.
>
> (2) Rules for applying paragraph (1).-For purposes of paragraph (1)-
>
> **********
>
> (C) Indirect ownership.-Property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. For purposes of the preceding sentence, a person shall be treated as a beneficiary of any trust only if such person has a present interest in the trust.
>
> **********
>
> (c) Special rule for interests in 2 or more closely held businesses.-For purposes of this section, interests in 2 or more closely held businesses, with respect to each of which there is included in determining the value of the decedent's gross estate more than 20 percent of the total value of each such business, shall be treated as an interest in a single closely held business.**********

Let us consider the situation of a decedent who owns six closely held businesses but his ownership is through six holding companies. The businesses are banks. Each bank is held by a separate holding corporation. The decedent is the principal owner of each holding company owning more than 90 percent of its stock. In turn, the holding company in each case is the principal owner of the bank owned by it, owning more than 90 percent of the stock. In each instance the bank owned by the holding company is the only asset of the holding company. It would appear that the regulations should provide that the estate of the decedent should be entitled to the benefits of Section 6166 even though the decedent's ownership of the six banks was through the six holding companies. Each of the banks were and are operating corporations carrying on a business. Under Section 6166(c) the six businesses are to be treated as an interest in a single closely held business. This statement deals with the issue of ownership through holding corporations.

In other words, the issue is, if the estate of the decedent qualifies for the benefits provided in Section 6166 in all other aspects, would the estate be denied these benefits because the decedent owned each of the businesses through the means of a holding company as is described in the preceeding paragraph. Or the issue might be stated - was the decedent the owner of an interest in a closely held business which was engaged in carrying on a business.

This issue should be decided in favor of the benefits of the section being granted to the decedent's estate by reason of Section 6166 itself as well as by an additional body of well established law.

Section 6166(b)(2)(C) provides:

> "property owned directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. **********"

The House report issued when this section was enacted stresses the point:

> "*****the bill provides that property (including stock or a partnership interest) owned directly or indirectly by or for a corporation, partnership, estate, or trust are to be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries."

In this case the banks, which were operating corporations and constitute an interest in a closely held business, are considered, according to Section 6166(b)(2)(C), to be owned not by the holding corporations but by the stockholders of the holding corporations, to wit: the estate of the decedent and it follows that the decedent was the owner of and was engaged in the conduct of a closely held business.

There is nothing in Section 6166 which provides that any interest in a closely held business shall be excluded from the benefits of the section by reason of the manner or form of the ownership of the business by the decedent. The test is - who is the real owner. Indeed, Section 6166(b)(2)(C) not only permits, but requires the tracing of ownership through intermediate entities, corporate, partnership, trust or estate, to determine the penultimate beneficial owner.

Such a holding as to the intent of Section 6166 is in accord with the law in similar situations. For instance, Section 544 of the Internal Revenue Code deals with constructive ownership for the purpose of determining whether a corporation is a personal holding company. That section contains the following:

> Sec. 544(a)(1) Stock not owned by individual - Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

The foregoing language of Section 544(a)(1) is almost identical with Section 6166(b)(2)(C) cited above.

The regulations issued on Section 544 further support the position that we are urging, to wit:

> Sec. 1.544-2. Constructive ownership by reason of indirect ownership.-The following example illustrates the application of section 544(a)(1), relating to constructive ownership by reason of indirect ownership:
>
> Example. A and B, two individuals, are the exclusive and equal beneficiaries of a trust or estate which owns the entire capital stock of the M Corporation. The M Corporation in turn owns the entire capital stock of the N Corporation. Under such circumstances the entire capital stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein. (Reg. Sec. 1.544-2)
>
> Sec. 1.544-6. Constructive ownership as actual ownership.- (a) General Rules. (1) Stock constructively owned by a person by reason of the application of the rule provided in section 544(a)(1),

> relating to stock not owned by an individual, shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 544(a)(2) in order to make another person the constructive owner of such stock, and
>
> *************
>
> (b) Examples. The application of this section may be illustrated by the following examples:
>
> Example (1). A's wife, AW, owns all the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P Corporation. Under the rule provided in section 544(a)(1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 544(a)(2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in paragraph (b) of Sec. 1.544-1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

This principle is also supported by the interpretation of Section 355 as set forth in the Regulations which have been promulgated thereunder. While Section 355 does not have the same language as to indirect ownership as does Section 6166, Section 355 is cited here to show that the principle runs through our tax law, that a holding company is engaged in the active conduct of a business if its subsidiary is so engaged.

Section 355 deals with the distribution of stock and securities of a controlled corporation. Immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business, and this trade or business must have been actively conducted throughout the 5-year period ending on the date of distribution. The Section 355 requires:

> (b) Requirements as to active business.-
>
> (1) In General.-Subsection (a) shall apply only if either-
>
> (A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or
>
> (B) Immediately before the distribution, the distributing corporations had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.
>
> (2) Definition.-For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if-
>
> (A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged.

On August 12, 1974, the IRS (Rev. Rul. 74-382, 1974-2 C.B.120) issued a revenue ruling relating to Section 355 in which it said:

> "CORPORATE REORGANIZATIONS--For valid business reasons a holding company distributes to its shareholders the stock of a subsidiary operating a manufacturing business and owning all the stock of other corporations engaged in a trade or business. After the distribution all of the holding company's assets consisted of the stock of another subsidiary having no business activity but owning other corporations engaged in a trade or business.
>
> "Held: The holding company is considered to meet the active trade or business requirement of Section 355(b) for purposes of determining whether the nonrecognition of gain or loss provisions of Section 355(a)(1) apply to the distribution."
>
> **********
>
> "in the instant case, all of the assets of Z consist of the stock of nine subsidiaries controlled by it immediately after the distribution, each of which is engaged in the active conduct of a

> trade or business. Therefore, Z is treated as engaged in the active conduct of a trade or business as defined in section 355(b)(2) of the Code."

CCH Volume 3, page 31066, in speaking of the active business requirement of Section 355 says:

> "Even if a corporation is not itself engaged in the active conduct of a business, it will be considered to be so engaged if all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged. Thus, a holding company may be considered to be engaged in the active conduct of a business."

In Sec. 267 of the I.R.C. which relates to transactions between related taxpayers, we find the same principle. Sec. 267(c)(1) provides:

> "(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;"

Example (1) in Regulations 1.267(c)1 again illustrates the principle of attribution of ownership which we are urging in reference to Sec. 6166, to wit:

> "(b) Examples. The application of section 267(c) may be illustrated by the following examples:
>
> Example (1). On July 1, 1957, A owned 75 percent and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267(c)(1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock." *************

Section 1563 of the I.R.C. deals with definitions and rules in reference to a controlled group of corporations. This Section likewise has an attribution of ownership provision which involves the same principle. Sec. 1563(e)(4) provides:

> "Attribution From Corporations-Stock owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (within the meaning of subsection (d) 5 percent or more in value of its stock in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation."

Regulation 1.1563-3(4) provides:

> "Attribution from corporations. (i) Stock owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (within the meaning of section 1563(d)) 5 percent or more in value of its stock in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.
>
> (ii) The provisions of this subparagraph may be illustrated by the following example:
>
> Example. Brown, an individual, owns 60 shares of the 100 shares of the only class of outstanding stock of corporation P. Smith, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, Brown is considered to own 30 shares of the S stock (60/100 x 50), and X is considered to own 18 shares of the S stock (36/100 x 50). Since Smith does not own 5 percent or more in value of the P stock, he is not considered as owning any of the S stock owned by P. If, in this example, Smith's wife had owned directly 1 share of the P stock, Smith (and his wife) would each own 5 shares of the P stock, and therefore Smith (and his wife) would be considered as owning 2.5 shares of the S stock (5/100 x 50)."

A reinforcing position taken by the IRS in letter ruling 7747007 (August 19, 1977) an estate qualified for installment payment of federal estate tax per Section 6166A attributable to a closely held business even though prior to that the decedent had transferred the business interest to a grantor trust. And since under IRC 674 the trust assets are considered owned by the grantor the decedent owned the business for purposes of Section 6166A.

Running like a gold thread through the fabric of our tax law is the fundamental concept that the activities of an actively conducted trade or business will be attributed to its ultimate beneficial owners, corporate, individual or otherwise, in disregard of the existence of intervening entities.

The Congress has consistently provided for the attribution of stock of corporations to the persons who own the stock. The regulations promulgated by the Internal Revenue Service have, likewise, followed this pattern. Another example of this principle can be found in Section 318 of the IRC. Attention is directed toward the following portions of that section.

Section 318(a)(2)(C) provides as follows:

> "If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proposition which the value of the stock which such person so owns bears to the value of all the stock in such corporation."

The regulations have, likewise, made this principle clear. Example 4 of the regulations for the foregoing provision is as follows:

> "A and B, unrelated individuals, own 70 percent and 30 percent, respectively, in value of the stock of Corporation M. Corporation M owns 50 of the 100 outstanding shares of stock of Corporation O, the remaining 50 shares being owned by A. Corporation M is considered as owning 100 shares of Corporation O, and A is considered as owning 85 shares."

There are a number of holdings which do not relate to our tax law but which do hold that a holding company is engaged in an active business if its subsidiary or subsidiaries are so engaged. In the landmark case relating to the Public Utility Holding Company Act, the Supreme Court of the United States in The North American Company versus the Securities and Exchange Commission 90 L ed 945, 327 U.S. 686 (1946), dealt with the case of whether a holding company was engaged in an active business if its subsidiary or subsidiaries are so engaged. This case is based on a dissimilar statute and it is a dissimilar situation but it is cited here to show the general holding that a parent corporation is engaged in the conduct of a business if its subsidiary is so engaged. The North American Company contended that it was not engaged in the gas and electric business. The opinion in that case has the following language (327 U.S. 692):

> "North American claims that its sole and continuous business has been that of acquiring and holding for investment purposes stocks and other securities of the subsidiaries, its relationship being essentially that of 'a large investor seeking to promote the sound development of his investment.'"

The opinion enumerated four ways in which a company may be in the operation of the business of selling, transporting, and distributing gas or electric energy in interstate commerce--then it adds the 5th, to wit:

> "(5). Or it may own or control securities of subsidiaries that do any of the foregoing acts." (327 U.S. 698)

In summary it would appear clearly that the situation described herein shows that the decedent was the owner of the banks and that the banks constituted a closely held business and that the decedent's estate is entitled to the benefits provided in Section 6166. This view is supported by the section itself and by interpretations in similar tax statutes and with the general view held by the courts.

I would particularly point out the similarity between Section 6166(b)(2)(C) and Section 544(a)(1) which are set forth in parallel columns.

Sec.6166(b)(2)(C):	Sec.544(a)(1)"
Property owned directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.******	Stock not owned by individual - Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries.

The regulations which have been promulgated in reference to Section 544 which are cited above provide that ownership through a parent corporation qualifies the parent as being engaged in a closely held business if its subsidiary or subsidiaries are so engaged. Sec. 6166 should be similarly interpreted.

We respectfully request that the regulations now being promulgated for Section 6166 make a similar provision. Our tax laws should adhere to the rule of equity that persons equally circumstanced be equally treated.

Thank you for considering this proposal.

Sincerely yours,

Carl T. Curtis

CTC:rf

Senator SYMMS. Thank you very much, Senator Curtis. I might compliment you that you had your statement timed perfectly, because you came through in less than 5 minutes and made your point.

Mr. CURTIS. Well, that's unusual. That's an accident.

Senator SYMMS. He reverted back to his days in the House of Representatives when they operated under the 5-minute rule.

Mr. Asbill, are you next?

Mr. ASBILL. Mr. Chairman, I'm going to try to do better than that and give you facts in about 5 minutes.

STATEMENT OF MAC ASBILL, JR., SUTHERLAND, ASBILL & BRENNAN, WASHINGTON, D.C.

Mr. ASBILL. I want to focus on a few selected practical problems arising under section 6166 that concern acceleration of the time for payment of tax; or, to put it the other way, the truncation of the deferral period that is provided by section 6166.

Two of these involve the failure of section 6166 to coordinate properly with section 303. Section 303 permits redemptions of stock of closely held businesses to have favored tax treatment under certain circumstances, and it grants this permission up to the amount of death taxes and administration expenses.

Section 6166 generally treats redemption of stock as a disposition of a closely held business, and if the disposition is large enough, it can trigger acceleration of the time for payment of the estate tax.

There is an exception in section 6166 for redemptions under section 303; but here is where the coordination falls down. Under section 6166 that exception applies only if the proceeds of the redemption are used to pay Federal estate tax. It does not permit that redemption to be without accelerating effect if the proceeds are used to pay interest, State death taxes, or administration expenses. We believe that the two sections should be coordinated in that regard so that the section 6166 provisions track the section 303 provisions.

The other situation where the two sections do not coordinate applies to the acquisition, after death, of new stock which has a substituted basis. I am referring here to an acquisition in a tax-free transaction such as a reorganization. Under section 303 any stock that has a substituted basis can enjoy the benefits of section 303 if the stock for which it was exchanged would have so qualified. By way of contrast, however, in section 6166 the substitution rule applies only if the exchange is a specified type of reorganization. It does not include all tax-free reorganizations as section 303 does. We think this discrepancy should be corrected.

The third problem I would like to call your attention to is the difference in the treatment of corporations and other businesses. I have just indicated how under section 303 you can withdraw funds from a corporation that is closely held for the purpose of paying death taxes without having that trigger acceleration. There is no similar rule for withdrawals from businesses held in the form of partnerships or proprietorships. We see no reason for that distinction and suggest that it be eliminated by granting similar treatment to withdrawals from partnerships and proprietorships.

Finally, I would like to call your attention to the situation where stock in a closely held business is redeemed by the issuance of a note by the redeeming closely held corporation. That note, although it is just as much an interest in the closely held business as the stock was, will trigger acceleration under the present law. It is treated as a disposition of the interest in the closely held business. We suggest that that treatment be changed. I might add, Mr. Chairman, that this change has been recommended by the American Bar Association.

That ends my testimony.

Senator SYMMS. Thank you very much.

Mr. Abramson?

STATEMENT OF RONALD D. ABRAMSON, SILVERSTEIN & MULLENS, WASHINGTON, D.C.

Mr. ABRAMSON. Thank you.

A few general comments:

Since section 6166 was enacted in 1958 there have been two major changes; first, a lengthening of the installment payment period from 10 years to 15 years, and an easing of the threshold requirements. However, since 1958 there have been almost no amendments of a technical nature. This has created several problems.

Under the current provision the aggregation rules are very complex and very overlapping. The treatment of interest as an administration expense is in fact a technical nightmare requiring 14 amended returns. And the historical synchronization between section 6166 and subchapter S in terms of the number of permitted owners no longer exists

In addition, section 6166 has not had the benefit of judicial resolution of technical disputes, which is often the case with other provisions of the Revenue Code.

As a result of all these problems, many tax practitioners have found section 6166 extremely difficult to rely on and have turned their attention and their focus to more elaborate and more costly estate-planning techniques.

In addition, it is very appropriate that the technical side of section 6166 should be addressed this year while a similar effort is underway with respect to subchapter S. Both of these provisions came into the law in 1958 as part of the Small Business Tax Revision Act of 1958. Thus, we believe it is very important for both of these small business provisions to undergo technical revision at the same time in this year.

Highlighting three particular areas, the first is the fact that, if there is a dispute under section 6166, you cannot go to court to resolve that dispute. As a result, the Internal Revenue Service rather than the courts becomes the final arbiter.

In our opinion, there can be no quarrel with the principle that taxpayers should be provided with the judicial form in all events. As a result of definitional complexities, it appears the taxpayers cannot go to court if the IRS denies the election. However, there is no indication that when the statute was enacted in 1958 and expanded in subsequent years that Congress ever intended to prevent taxpayers from going to court. What we have, in effect, is a denial of due process that has occurred merely by accident, not by design.

A particular situation involves reviewability of Tax Court decisions by the circuit court, and we feel here that decisions of the Tax Court in this area should be reviewable by the circuit courts, as is the case with all other provisions. There are several penalty sections in the law, which are strengthened by S. 2479, that would prevent any abuse of the review process. So we believe that decisions of the Tax Court should be reviewable in the same manner as all other decisions.

Another situation which requires immediate attention is the aggregation rule. Since 1958 business structures on the whole have become much more complex. Senator Curtis has already examined the situation involving holding companies. Another common situation is brother-sister companies where a taxpayer has an ownership interest in more than one business entity. Under the current aggregation rule the taxpayer must own at least 20 percent of each of those entities. On the other hand, where the taxpayer has an interest in only one entity, an alternative numerical test comes into play and the section is available if there are 15 or fewer owners, whether or not the decedent owns less than 20 percent.

Thus, a taxpayer, where that taxpayer is involved in more than one business, suffers a penalty if there are more than five equal owners, because in such event the taxpayer can never own 20 percent or more of that business. Since section 6166 is designed, as pointed out, to extend its benefits to an entity that has up to 15 owners, the aggregation rule as now in the statute undercuts the intention of the statute to permit up to 15 owners.

Accordingly, here, we recommend that the aggregation rule be amended so that section 6166 can apply to each entity owned by the decedent where either the decedent owned 20 percent or more of the entity or the entity had 15 or fewer owners.

Finally, the historical linkage between the maximum number of owners permitted by subchapter S and the maximum number of owners permitted by section 6166 no longer exists. That linkage should be restored immediately. The linkage existed from 1958 until 1981, but in the Economic Recovery Tax Act the linkage was severed. We recommend that the linkage be reassembled and that the number of owners for subchapter S be coordinated with the number of owners for section 6166.

Accordingly, if the maximum number of owners for subchapter S is increased to 35, as has been proposed in the subchapter S bill, we believe a corresponding change should be made for section 6166.

Finally, the task force would like to thank the Senator for holding these hearings and to second your comments about Anne Canfield's tremendous contribution.

[The prepared statement of Senator Carl T. Curtis follows:]

WRITTEN STATEMENTS

1. PRESENTATION BY CARL T. CURTIS

Mr. Chairman, I wish to express my deep gratitude for the opportunity to appear before this Subcommittee as a member of this panel, representing the Task Force on Technical Revision of Section 6166.

With me today are Mr. Mac Asbill, Jr., of the firm of Sutherland, Asbill & Brennan, and Mr. Ronald D. Abramson, of the firm of Silverstein and Mullens.

Section 6166 was enacted by the Congress in order to make it possible for more businesses to be continued by the families of the decedent rather than forcing the sale of such business for the payment of state taxes. Estate taxes are very burdensome, especially in this time of inflated values. A very modest estate can amount to $100,000 after all adjustments, deductions and credits are taken into account. The rate of tax reaches 30 percent on the first $100,000 of the taxable estate and is graduated upward.

Section 6166 provides that is case of an estate where the decedent was the owner of an interest in a closely held business, that the estate tax may be paid in installments over a period of up to 15 years, with a reduced interest rate of four percent on a portion of the unpaid balance. Without Section 6166, many small and medium size family businesses would have to be sold to pay the estate tax. In many situations the only likely buyers are the very large corporations. Thus, Section 6166 is necessary if the decedents' families are going to continue with the family business.

Today, I wish to direct your attention to what is an interest in a closely held business. If a decedent owned a bank, that is ownership in a closely held business. The decedent is engaged in a trade or business. But, suppose that a decedent was the owner of a holding company, which in turn was the sole owner of the stock of the bank—did the decedent own an interest in a closely held business. Was the decedent engaged in a trade or business?

Based upon what clearly appears to be the intent of Congress, the answer is yes. The decedent was engaged in a trade or business, because Section 6166(b)(2)(c) provides: "(C) Indirect Ownership—Property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries."

In support of this contention, I would like to submit a brief I prepared which is in the form of a letter to Mr. Douglass W. Charnas, of the Internal Revenue Service, dated March 17, 1980, to be printed at the end of my remarks.

In my opinion Congress intended that the benefits of Section 6166 should be available to families of decedents where the decedents were the real owners of the trade or business, regardless of the form of the business organization in which the decedents chose to operate.

I will not take the Committee's time to cite a long list of Sections of the Internal Revenue Code, which have similar language on indirect ownership and where the regulations and rulings hold that if a parent corporation owns a subsidiary and the subsidiary is engaged in a trade or business that the parent corporation and the owner thereof are engaged in a trade or business.

The regulations for Section 6166 have not yet been issued. We need legislation to clarify the evident intent of Congress in reference to holding companies. Two Private Letter Rulings, Nos. 8130175 and 8134012, were issued by the IRS, which set forth the principle that if a parent corporation owns a subsidiary which is engaged in a trade or business, that the parent corporation is not so engaged. Private letter rulings are not to be cited as precedent, but these two letter rulings are not in accord with what Congress intended when it wrote Section 6166. They do point out the need for the enactment of S. 2479.

Mr. Chairman, I would now call on Mr. Mac Asbill for his statement, to be followed by Mr. Ronald Abramson.

II. PRESENTATION BY MAC ASBILL, JR.

I will focus briefly, if I may, on selected practical problems arising under Section 6166 after the death of the owner of the closely held business. These problems require attention if Section 6166 is to function effectively and fairly.

The first of these problems illustrates, I think, an inadvertent failure to coordinate Section 6166 with its counterpart, Section 303. The latter section permits redemption of stock of a qualifying closely held business corporation, up to the amount of death taxes, interest, and administration expenses attributable to that business, without the dividend treatment that would otherwise be accorded such a redemption. Congress intended to permit the redemption under Section 303 to be spread over the 15-year deferral period permitted under Section 6166. The provisions of Section 6166 require truncation of the deferral period when 50 percent of an interest in a closely held business is disposed of. There is an exception for Section 303 redemptions, but only if the amount received in redemption is promptly applied to the payment of the estate tax itself. The exception does not apply where the redemption proceeds are used to pay administration expenses, including interest on deferred estate tax, or to pay certain state death taxes, although Section 303 itself permits the redemption to cover such amounts. The result, in many cases, is that it is impossible for an estate to utilize the 15-year deferral privilege under Section 6166 where funds to pay the taxes and administration expenses must be withdrawn from the closely held corporation under Section 303. The bill eliminates this anomaly.

Another example of lack of coordination is the fact that Section 303 applies to any new stock acquired after death that has a substituted basis (e.g., stock received in a tax-free reorganization), provided the section would have applied to the old stock for which the new stock was exchanged. In contrast, Section 6166 provides an exception to the acceleration rule in the event of such an exchange only if the exchange qualifies as a specified type of reorganization. The bill achieves parallel treatment by extending the Section 6166 exception to embrace all reorganizations.

There is another problem resulting from a discrepancy in the treatment of corporations and other forms of businesses. Although, as I have just described, certain withdrawals of funds from a corporate business under Section 303 for the purpose of paying death taxes will not trigger acceleration, similar treatment is not granted to withdrawals from a business operated as a partnership or a proprietorship. There appears to be no logical reason for such a distinction and this bill would provide parallel treatment by permitting the same type of withdrawal from a partnership or proprietorship that is permitted from a corporation.

My last example involves the situation where the stock of the closely held business is redeemed by issuance of a corporate note which can be paid off over the 15-year deferral period. Current law treats this as a disposition of an interest in the closely held business that can terminate the estate's right to defer payment of the estate tax. This seems inappropriate. It would be more in keeping with the purpose of Section 6166 to treat the corporate note as merely a different form of interest in the business, with a disposition of that interest occurring only when the note is disposed of or satisfied, rather than as a disposition of that interest. The bill adopts this approach, which has also been recommended by the American Bar Association.

III. PRESENTATION BY RONALD D. ABRAMSON

In addition to the seas already addressed by Senator Curtis and Mr. Asbill, there are numerous other technical problems which continue to plague Section 6166. Since this section was enacted into law in 1958, there has been a lengthening of the installment payment period from 10 years to 15 years and a significant easing of the threshold requirements which must be satisfied in order to utilize this section.

However, since 1958 there have been almost no amendments of a technical nature. Thus, under the current provision, the aggregation rules are extremely complex and overlapping, the treatment of interest as an administratioin expense is a technical nightmare requiring, in effect, 14 amended returns, and the historical synchronization between Section 6166 and Subchapter S, in terms of the number of permitted owners, no longer exists. In addition, Section 6166, as explained hereafter, has not had the benefit of judicial resolution of technical disputes which occurs so often with other provisions of the Internal Revenue Code. As a result, many tax practitioners have found Section 6166 very difficult to rely on and have turned their focus and attention to more elaborate and costly estate planning techniques.

It is also appropriate that the technical side of Section 6166 should be addressed in 1982 while a similar effort is underway with respect to Subchapter S. Both Section 6166 and Subchapter S were enacted as part of the same Small Business Tax Revision Act of 1958. Thus, it is very important for both of these small business provisions to undergo technical revision at the same time in 1982.

I would like to highlight three particular situations which require an immediate legislative solution. The first is the fact that disputes under Section 6166 cannot be resolved in court. One of the hallmarks of the Federal tax system is the ability of impartial judges to resolve disputes between taxpayers and the Internal Revenue Service. The courts are the final arbiter. In fact, the Tax Court was created to provide taxpayers with a judicial forum without requiring the prior payment of amounts in dispute. Thus, there can be no quarrel with the principle that taxpayers should be provided with a judicial forum in all events.

As a result of complexities, it appears that taxpayers cannot go to court in the event the Internal Revenue Service denies the executor's election to use Section 6166. There is no indication, however, that when the enabling legislation was enacted in 1958, Congress intended that taxpayers should be prevented from going to court to settle disputes with the Revenue Service. What is, in effect, a denial to taxpayers of due process in the case of controversies arising under Section 6166 appears to have been caused purely by accident and not by design.

We note that both the Senate and the House, on separate occasions, have provided for a nonreviewable Tax Court forum for Section 6166 controversies. The Senate amendment, which is contained in H.R. 4717, is now awaiting action by the Conference Committee.

With respect to reviewability, all decisions of the Tax Court now are reviewable by one or more circuit courts. Moreover, in order to utilize the review process, the taxpayer must pay the amount in dispute or utilize an expensive bonding procedure. In addition, there are several penalty provisions which can be applied in the event the review process is abused. Accordingly, we believe that decisions of the Tax Court involving Section 6166 should be reviewable in the same manner as all other decisions of that court.

The second situation I would like to mention involves the aggregation rule. Since 1958 when Section 6166 was enacted, business structures have become increasingly complex. Senator Curtis has already examined the situation involving holding companies. It is extremely common for taxpayers to have an ownership interest in more than one business entity. Under the current aggregation rule in Section 6166 dealing with multiple entities, the taxpayer must own at least 20 percent of each entity. On the other hand, if the taxpayer has an interest in only one entity, an alternative numerical test comes into play and Section 6166 is available where there are 15 or fewer owners, even if the decedent own less than 20 percent. Thus, where a taxpayer is involved in more than one business, there is a penalty if there are more than five equal owners because the taxpayer will own less than 20 percent of each business and lose the benefits of Section 6166. Since Section 6166 is designed to extend its benefits to an entity that has up to 15 owners, the aggregation rule undercuts the intention of the statute. Accordingly the rule should be amended to permit Section 6166 to apply to each entity owned by the decendent where either the decedent owned 20 percent or more of the entity or the entity had 15 or fewer owners.

My final point is that the historical linkage between the maximum numbers of owners permitted by Subchapter S and Section 6166 should be restored. That linkage existed from 1958 until broken in 1981 by the Economic Recovery Tax Act. An entity should qualify under Section 6166 if there are 25 or fewer owners—the maximum permitted by Subchapter S. Likewise, if the maximum number of owners for Subchapter S purposes is increased, as has been proposed, a corresponding change should be made to Section 6166.

IV. MEMBERS OF THE TASK FORCE ON TECHNICAL REVISION OF SECTION 6166

The following law firms and accounting firms from throughout the country are members of the Task Force on Technical Revision of Section 6166. Listed beside each firm is the name of the person who is principally involved with Section 6166 and related matters:

Arthur Andersen & Co., Sam Murray; Baker & Botts, J. Thomas Eubank; Cox, Castle & Nicholson, Jeffrey Lapota; Deloitte, Haskins & Sells, Alexander Zakupowsky; Dow, Lohnes & Albertson, Bernard J. Long, Jr.; Ernst & Whinney, Herbert J. Lerner; Frank, Bernstein, Conaway & Goldman, Shale D. Stiller; Giordano, Halleran & Crahay, John A. Aiello; Gordon, Feinblatt, Rothman, Hoffberger & Hollander, Marc P. Blum; Greenebaum Doll & McDonald, Martin S. Weinberg; Hogan & Hartson, Sara-Ann Determan; and Jones, Walker, Waechter, Poitevent, Carrère & Denègre, Edward B. Benjamin, Jr.

Katten, Muchin, Zavis, Pearl & Galler, Sheldon I. Banoff; Lidell, Sapp, Zivley, Brown & LaBoon, Walter Zivley; Nelson & Harding, Senator Carl Curtis; Peat, Marwick, Mitchell & Co., Gilbert Bloom; Sill, Beck Cummis Radin & Tischman, Herbert L. Zuckerman; Prince, Yeates & Geldzahler, David S. Geldzahler; Shea & Gould, James C. Heinhold; Silverstein and Mullens, Ronald D. Abramson; Sutherland, Asbill & Brennan, Mac Asbill, Jr.; and Vinson & Elkins, Marvin K. Collie.

V. DETAILED WRITTEN STATEMENT

The Task Force on Technical Revision of Section 6166 submitted a detailed written statement in connection with a similar hearing on November 4, 1981 before the Subcommittee on Estate and Gift Taxation of the Committee on Finance. That statement analyzes each of the provisions of S. 2479. Accordingly, the Task Force is not submitting another detailed statement at this time.

Senator SYMMS. Thank you all very much for very excellent statements which will certainly, in my opinion, be very helpful for us as we move forward with this legislation. It certainly makes the example of the need for our form of legislation which will make the corrections.

I thank you all very much.

The next panel consists of Stanley Breitbard, chairman of the estate planning subcommittee of the American Institute of Certified Public Accountants; Mr. Bernard Aidinoff, chairman-elect of the tax section of the American Bar Association; John Wallace, chairman of the estate and gift tax committee of the American College of Probate Counsel; and Don Thurmond, group vice president, Trust Company Bank, Atlanta, Ga., on behalf of the American Bankers Association.

Mr. Breitbard, if you would like to start, please go right ahead.

STATEMENT OF STANLEY H. BREITBARD, CHAIRMAN, ESTATE PLANNING SUBCOMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, D.C.

Mr. **Breitbard**. Thank you, Senator. I appear before you today as chairman of the estate planning subcommittee of the American Institute of CPA's Federal tax division, and in this capacity I represent 175,000 CPA's, many of whom spend a substantial portion of their time in dealing with Federal estate tax matters.

The Federal tax division of the AICPA believes that code section 6166 is of vital importance in protecting closely held businesses against forced sales to pay estate taxes. Our collective experience confirms that section 6166 is working to achieve its goal of reducing tax hardships as a result of the death of an owner of a closely held business. But there are still a number of technical deficiencies in the section that should be corrected to make its operations fairer and simpler.

S. 2479 addresses some of these issues, and we would like to express our support for certain portions of the bill that we have analyzed. We also have some suggested additions that we think might improve the bill.

We support the amendment that would allow indirect as well as direct ownership of a business to qualify for section 6166 treatment. We believe it was the intent of Congress to allow the benefits of section 6166 regardless of the form of the decedent's ownership.

The Internal Revenue Service has ruled that a holding company was not carrying on a trade or business by merely holding the stock of its wholly owned subsidiaries, even though the subsidiaries were actively engaged in trades or businesses. This position unfairly penalizes those businesses that have chosen to structure themselves in multiple corporate form. We support the bill's correction of this inequity.

We also support the amendment that permits indebtedness to qualify for deferral benefits. The amendment should apply to situations where an estate acquires the indebtedness from the sale of the business prior to death of the decedent and the business interest would have qualified for section 6166 treatment prior to sale. Estate tax should then be paid as the loan proceeds are collected. We believe that section 6166 should apply to both equity and indebtedness held by a decedent.

The bill does not change the complex and arbitrary definition of an interest in a closely held business under present law. We believe that the current tests of number of persons or percentage interest should be replaced with a nonmarketability test such as presently contained in section 6166(b)(7). Under this test, stock or partnership interests would qualify if there was no market on a stock exchange or in an over-the-counter market. Proprietorship interests would automatically qualify as under present law. The advantages of such a test are both simplicity and fairness, and a return to congressional purpose regarding estate tax deferral. The nonmarketability test would also eliminate the need for complex constructive ownership rules

It should not be necessary to construct cutoffs based on numerical tests when a substantive test would serve the purpose. Under present law an estate owning 19 percent of the stock of a corporation with 16 shareholders would not qualify for 6166 deferral, whereas an estate owning 20 percent of the stock of a New York Stock Exchange corporation would qualify.

With a nonmarketability test, a decedent could own many interests in qualified, closely held businesses. A de minimis rule should be adopted for purposes of aggregating these interests to reach the 35-percent threshold. We believe that each interest should be at least 5 percent of the adjusted gross estate in order to be aggregated for purposes of determining the decedent's total interests in closely held businesses.

We support two amendments concerning acceleration which we consider to be the most important provisions, because they are the most common circumstances.

First, when an estate sells its interest in a closely held business for a note, this event should not cause acceleration. This is also consistent with our earlier comments regarding the elimination of statutory bias between indebtedness and equity.

Second, we support the expansion of the acceleration exception for section 303 redemptions to permit the proceeds of such redemptions to be used for any of the specified purposes of section 303(a), and to provide treatment for partnerships and proprietorships equivalent to section 303 for corporations.

With regard to interest on the tax deferred, the maximum amount of estate tax to which the 4-percent rate of interest applies is decreasing each year as the unified credit increases. By 1987 the 4-percent portion will be only $153,000.

We believe that this reduction in the 4-percent portion may have been inadvertent, and we propose that a provision be added to the bill which would base the 4-percent portion of the net estate tax on the ratio of the interest in the closely held business, up to the current $1 million limit, to the adjusted gross estate. This would serve to allocate the unified credit between the portion of estate tax related to the closely held business and the balance of estate tax.

I might just add, in closing, that we support, as others have, the resolution of this deficiency in the current law in the absence of an opportunity to bring to court disputes involving section 6166. This puts the IRS in the position of ultimately resolving all section 6166 conflicts, and we support the provision of the bill that gives the Tax Court the power to make declaratory judgments.

I appreciate this opportunity to present our views.

Senator SYMMS. Thank you very much for an excellent statement which will be very helpful as we mark this bill up.

Mr. Aidinoff.

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN-ELECT, TAX SECTION, AMERICAN BAR ASSOCIATION, WASHINGTON, D.C.

Mr. AIDINOFF. I am the chairman-elect of the section of taxation of the American Bar Association. I am here to express the section's views on S. 2479 and on S. 1983, the disclaimer legislation.

As you know, Mr. Chairman, the section of taxation has had a continuing interest in section 6166 of the code. It has previously submitted a statement to your subcommittee recommending various improvements, many of which have been included in S. 2479.

Senator SYMMS. Well, we appreciate your continued efforts on this.

Mr. AIDINOFF. I would like to focus on a couple of the areas where we believe that further improvements can be made in S. 2479.

As the previous witnesses have indicated, the definition of an interest in a closely held business requires modification. The section of taxation believes that a very simple test should be used, one which would turn entirely on the question of whether the particular interest in a business is marketable or not. Section 6166, under our proposal, would only be applicable to nonmarketable interests. This would eliminate distinctions among partnerships, proprietorships, and corporations, and would avoid all of the problems relating to holding companies, and whether the particular entity is engaged in a trade or business.

The marketability test has worked very well in other areas of the Internal Revenue Code; such a test would be easy to administer and would be functionally fair. And, as a result, the statute could be considerably simplified by eliminating the complex attribution rules that are presently in S. 2479.

With respect to the aggregation rules, we are in agreement with the other witnesses that the threshold limit should be reduced to 5 percent.

I would also like to comment on the provisions with respect to interest on unpaid installments. We believe that a much better approach than the approach taken in S. 2479 would be to disallow interest on section 6166 payments as an administration expense, and substitute a reduced rate of interest. For example, if the rate of interest were 50 percent of the rate that it otherwise would be, and no deduction allowed, it would be a lot easier to administer section 6166, and economically the same results would be achieved as allowing a deduction for administration expense without the necessity for all of the administrative adjustments that would be required if the existing bill were enacted.

We are in agreement with the previous witnesses with respect to their comments on section 303 and the use of notes.

I would also like to comment briefly on behalf of the section of taxation on S. 1983, the disclaimer legislation with respect to future interests. We are in agreement that S. 1983 corrects a situation which should be corrected. However, we believe that a greater change would be appropriate. The statute should provide that in the case of any future interest in property, a disclaimer should be possible not later than 9 months after the event when the taker of the interest is finally ascertained. In other words, we are advocating a statute that would overrule the *Jewett* case.

Thank you.

Senator Symms. Thank you very much for your statement. We appreciate it greatly.

John Wallace.

STATEMENT OF JOHN A. WALLACE, CHAIRMAN, ESTATE & GIFT TAX COMMITTEE, AMERICAN COLLEGE OF PROBATE COUNSEL, ATLANTA, GA.

Mr. Wallace. Thank you, Mr. Chairman. I am pleased to again testify before your subcommittee on matters of interest to the American College of Probate Counsel, which represents an organization of more than 2,300 practicing attorneys in the United States, including Mr. Gigray of Caldwell, Idaho, well-known to the chairman, who have an interest in trusts and estates and related tax laws.

Senator Symms. I might just mention I have known him since I was a young child.

Mr. Wallace. He says he's back planning estates as well as he can, Mr. Chairman.

We have filed a statement with the subcommittee on S. 2479, supporting many provisions of the bill and making several recommendations that differ in some respects and add in other respects to the points made in that legislation.

I would like to confine my oral comments this afternoon to two major points that are of concern to the college.

First, we think it's worthy to, again, reflect on the fact that we are not talking about not paying tax. When you talk about tax deferral, you are speaking in terms of paying every dime of tax that is due the Federal Government. All that we are asking for here, Mr. Chairman, are terms that allow a small business to live with the tax burdens that are thrust upon it when a substantial owner of that business dies.

The college is concerned that since 1976 the economic relief inherent in estate tax deferral has been declining steadily. In 1976 the interest rate that attached to deferred tax payments was bifurcated into two parts. The special preferential interest rate that has been given since 1958 for estate tax deferral was limited to one small portion of the tax. The balance was then tied to the interest rate that attaches to tax obligations generally and that now runs at the unbelievable rate of 20 percent a year. This is simply out of the reach of small businesses. And, after all, the statute is designed to keep small businesses in place so that they can produce the cash needed to pay the estate tax.

We have made two recommendations in our statement which I would like to refer again to here. First, we would recommend that the 4-percent portion—that is, the first portion of the deferred estate tax that has a favorable interest rate—be separated from the unified credit. At the present time the unified credit, as it increases, is decreasing the amount of the 4-percent portion that receives this preferential interest rate. We think this is bad policy. The unified credit ought to be viewed as that amount above which estates ought to be taxed. Then, once the tax burden falls, estate tax deferral ought to apply to that burden. It is simply wrong, in our judgment, to link the two together.

Second, we would separate the interest rate charged on deferred estate tax payments under section 6166 from the interest rate charged on other tax obligations. The focus of those two interest rates are different. If you are looking at the interest that is charged on tax obligations generally, that is, upon taxpayers who pay their taxes late or underpay their taxes, you must charge a market rate of interest or people will be borrowing from the Government at every turn; in short, tax deferral should be discouraged in this context.

The interest rate that ought to apply, Mr. Chairman, on deferred estate tax should encourage deferral, not discourage it. So we submit that the two concepts ought to be separated from each other as a matter of policy, and Congress should then set what we feel is a sufficiently low rate to enable small businesses to pay the estate taxes that are indirectly thrust upon them when a substantial owner dies.

There are collateral questions that need to be considered when that rate is set. One is whether the interest charged will be deducted and, if so, on what basis. Second, the length of time for estate tax deferral must be established. We are concerned that once the length of time was extended from 10 to 15 years, many felt that if a low rate of interest was attached to estate tax deferral the economic benefits would be too great.

So now we have a long period of time to pay an onerous interest rate. We would prefer a lower interest rate and would agree, if necessary, to a shorter period of deferral.

The second point I would like to make is the absence of judicial review in the estate tax deferral area. At the moment, if the Internal Revenue Service disagrees with a taxpayer about estate tax deferral matters, there is no way the taxpayer can seek relief in the courts. That problem is going to be addressed soon in Congress, there is no question about that. As a matter of fact, I think that some declaratory judgment procedure is on the verge of being passed now. We have some suggestions in that area that we think are improvements to this proposed remedy. I note that the Tax Section of the American Bar Association is in agreement with the proposal that we recommend to the subcommittee in this area.

We thank you once again for holding these hearings and for your continuing interest in estate and gift tax matters.

Senator **SYMMS**. Thank you very much, Mr. Wallace.

STATEMENT OF DONALD W. THURMOND, GROUP VICE PRESIDENT, TRUST CO. BANK, ATLANTA, GA, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, WASHINGTON, D.C.

Mr. **THURMOND**. Thank you, Mr. Chairman.

I am a member of the Taxation Committee of the Trust Division of the American Bankers Association, and I am testifying today on behalf of the American Bankers Association. Our members have had considerable experience in the planning and administration of estates with closely held businesses in them and are very interested in this topic.

In general the ABA does support many of the provisions of S. 2479. We have been concerned for several years with the operation of section 6166. An ABA memorandum dated August 27, 1980, made recommendations for a change, and we are attaching that memorandum with our written statement.

Many of the changes which we have recommended in that memorandum have been included. There are some that were not included, and we would like for them to be given further consideration; and there are some additional suggestions we would like to make.

Section 3 of S. 2479 contains changes that would eliminate acceleration of deferred estate tax payments in certain situations. In general, section 6166(g) provides that acceleration shall occur if one-third or more in value of an interest in a closely held business is distributed, sold, exchanged, or otherwise disposed of.

An exception is currently created by section 6166(g)(1) (B) and will be continued under 2479 that provides for "A transfer of property of the decedent to a person entitled by reason of the decedent's death to receive such property under the decedent's will, the applicable law of dissent and distribution, or a trust created by the decedent." This exception would not apply if the trust was created by another person but included in the decedent's gross estate. A typical situation of this would be a marital deduction trust.

All trust property included in a decedent's estate for tax purposes should be treated in the same manner as any other property in the decedent's estate, and we would suggest that the words in this section be changed to "a trust included in the decedent's gross estate," rather than "one created by the decedent."

Section 6166(g)(2) provides that if an estate has undistributed net income for any taxable year ending on or after the due date for the first installment, the executor shall on or before the date for filing the return for such year pay an amount equal to such undistributed net income.

We disagree with the concept of "the undistributed net income." We think the rule is unsound, and we strongly suggest that this be stricken.

There is a provision that interest on estate tax deferral, whether it is paid to the Federal Government or to a State, is considered an adjusted itemized deduction for alternate minimum tax purposes. We think this is inappropriate where you are dealing with a time of hardship and think that this should be an exception to the adjusted itemized deduction concept of the alternative minimum tax.

Under existing policy the IRS will allow an interest on estate tax deferred by section 6166 as an administration expense deduction under 2053 only after it had been paid, and this had been alluded to in the previous testimony. S. 2479 would eliminate some of this complexity by allowing the deduction up front and changing the interest rate to a flat rate over the period of time. We support the flat rate concept. It is difficult to plan the administration of an estate with the fluctuating rate and with the high rate that currently exists.

We, however, think that this proposed approach needs some adjustment. We suggest that this approach be refined in certain respects or that, really, a simpler approach be used. The simpler approach which we suggest is similar to that of the tax section; what we would do, would eliminate the interest as a deduction for estate tax purposes. We would keep the qualified interest rate concept. And what we would do instead of reducing the tax, we would simply halve the interest rate, or use a reciprocal of the estate tax, which in 1985 the reciprocal would be 50 percent, times the qualified interest rate, and use that as the rate that would apply the entire deferred period. We think this would add greatly to the simplification and strongly suggest that this be done.

If a simplified approach is not used, then we ask that you seriously consider the additional suggestions we make on the qualified interest approach in our written statement.

We appreciate the opportunity to be able to testify of this subject today, and welcome any questions you might have.

[The prepared statements of the previous panel follow:]

Statement of Stanley H. Breitbard

on Behalf of

American Institute of Certified Public Accountants

Submitted to the

Subcommittee on Estate and Gift Taxation

Senate Committee on Finance

Holding Hearings on

Section 6166 Technical Revision Act of 1982

S. 2479

May 27, 1982

Good afternoon! I am Stanley Breitbard. I appear before you today as chairman of the AICPA Federal Tax Division's Subcommittee on Estate Planning. In this capacity I represent 175,000 CPAs, many of whom spend a substantial portion of their time in dealing with federal estate tax matters.

The Federal Tax Division of the American Institute of CPAs believes that Internal Revenue Code Section 6166 is of vital importance in protecting closely-held businesses against forced sales to pay estate taxes. Our collective experience confirms that Section 6166 is working to achieve its goal of reducing tax hardships as a result of the death of an owner of a closely-held business.

Nonetheless, there are a number of technical deficiencies in Section 6166 that should be corrected to make the operations of the Section fairer and simpler. S. 2479 addresses some of these issues and we would like to express our support for certain portions of the Bill that we have analyzed. We also have some suggested additions to improve the bill.

SECTION 2. INTEREST IN A CLOSELY-HELD BUSINESS

We support the amendment that would allow indirect, as well as direct, ownership of a business to qualify for Section 6166 treatment. We believe it was the intent of Congress to allow the benefits of Section 6166 regardless of the form of the decedent's ownership.

The Internal Revenue Service has ruled that a holding company was not carrying on a trade or business by merely holding the stock of its wholly-owned subsidiaries, even though the subsidiaries were actively engaged in trades or businesses. This position unfairly penalizes those businesses that have chosen to structure themselves in multiple corporate form. The Bill corrects this inequity.

We also support the amendment that permits indebtedness to qualify for deferral benefits. The amendment should apply to situations where an estate acquires the indebtedness from the sale of the business prior to death of the decedent and the business interest would have qualified for Section 6166 treatment prior to sale. Estate tax should then be paid as the loan proceeds are collected. We believe that Section 6166 should apply to both equity and indebtedness held by a decedent.

The Bill does not change the complex and arbitrary definition of an interest in a closely-held business under present law. We believe that the current tests of number of persons or percentage interest should be replaced with a nonmarketability test such as presently contained in Section 6166(b)(7). Under this test, stock or partnership interests would qualify if there was no market on a stock exchange or in an over-the-counter market. Proprietorship interests would automatically qualify as under present law.

The advantages of such a test are simplicity and fairness, and a return to Congressional purpose regarding estate tax deferral. The nonmarketability test would also eliminate the need for complex constructive ownership rules.

It is not necessary to construct cutoffs based on numerical tests when a substantive test would serve the purpose. Under present law, an estate owning 19% of the stock of a corporation with 16 shareholders would not qualify for Section 6166 deferral, whereas an estate owning 20% of the stock of a New York Stock Exchange corporation would qualify.

With a nonmarketability test, a decedent could own many interests in qualified closely-held businesses. A de minimis rule should be adopted for purposes of aggregating these interests to reach the 35% threshold. We believe that each interest should be at least 5% of the adjusted gross estate in order to be aggregated for purposes of determining the decedent's total interests in closely-held businesses.

SECTION 3. ELIMINATION OF THE ACCELERATION OF ESTATE TAX PAYMENTS IN CERTAIN SITUATIONS

We support two amendments concerning acceleration which we consider to be the most important provisions, because they are the most common circumstances.

First, when an estate sells its interest in a closely-held business for a note, this event should not cause acceleration. This is also consistent with our earlier comments regarding the elimination of statutory bias between indebtedness and equity.

Second, we support the expansion of the acceleration exception for Section 303 redemptions as follows:

(a) to permit the proceeds of such redemptions to be used for any of the specified purposes of Section 303(a), and

(b) to provide treatment for partnerships and proprietorships equivalent to Section 303 for corporations.

We feel that these amendments are needed to provide equity under Section 6166.

SECTION 4. INTEREST ON ESTATE TAX FOR WHICH PAYMENT IS EXTENDED UNDER SECTION 6166

The maximum amount of estate tax to which the 4 percent rate of interest applies is decreasing each year as the unified credit increases. By 1987, the "4 percent portion" will be $153,000.

We believe that this reduction in the "4 percent portion" may have been inadvertent rather than intentional. We propose that a provision be added to the Bill which would base the 4 percent portion of the net estate tax on the ratio of the interest in the closely-held business (up to $1,000,000) to the adjusted gross estate. This would serve to allocate the unified credit between the portion of estate tax related to the closely-held business and the balance of estate tax.

SECTION 5. DECLARATORY JUDGMENTS RELATING TO SECTION 6166

Perhaps the most glaring deficiency of the current law is the absence of opportunity to bring to court disputes involving Section 6166. This circumstance puts the Internal Revenue Service in the position of ultimately resolving all Section 6166 conflicts. We support the provision of the Bill that gives the Tax Court the power to make declaratory judgments regarding issues arising under Section 6166.

* * * * *

We appreciate the opportunity to have presented our views on this subject of major importance to the smaller business community. Thank you.

STATEMENT OF M. BERNARD AIDINOFF
CHAIRMAN ELECT
SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE
SENATE FINANCE COMMITTEE

May 27, 1982

Summary of Principal Points

A. The Tax Section supports action in the §6166 area and urges

(1) Substitution of a nonmarketability test for the definition of a "closely held business interest";

(2) Adoption of the 5% aggregation test proposed by S. 2479;

(3) Reduction of the interest rate applicable to deferred payments of estate tax under §6166 and elimination of the interest deduction for estate tax purposes;

(4) Adjustment of the acceleration rules to permit (i) redemption of the stock or partnership interest for notes of the business and (ii) protection for §303 redemptions used to pay taxes, interest and administration expenses; and

(5) Judicial review of §6166 issues in the same manner as tax liability issues rather than through a special declaratory judgment procedure.

B. The Tax Section supports legislation which would permit disclaimer of a future interest in property within nine months after the event when the taker of the interest is finally ascertained and the interest becomes indefeasible.

STATEMENT OF M. BERNARD AIDINOFF

CHAIRMAN ELECT

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

OF THE

SENATE FINANCE COMMITTEE

May 27, 1982

Re: S. 2479 -- Deferred Payment of Estate Taxes Where Closely Held Businesses are Involved

S. 1983 -- Estate and Gift Tax Treatment of Disclaimers of Property Interests Created by Transfers Before November 15, 1958

Mr. Chairman and Members of the Committee:

My name is M. Bernard Aidinoff. I am Chairman Elect of the Section of Taxation of the American Bar Association. In that capacity, I am pleased to express the views of the Section of Taxation of the American Bar Association with regard to the bills dealing with deferred payment of estate taxes where closely held business interests are involved and the time period for disclaimer of future interests.

I. S. 2479 - Deferred Payment of Estate Taxes

Mr. Chairman, the Tax Section has had a continuing interest in the subject of deferred payment of estate taxes, and submitted a statement to this Subcommittee on December 17, 1981 recommending improvements to §6166 and related sections of the Internal Revenue Code which deal with this subject matter.

Many of the recommendations which the Section of Taxation submitted on December 17, 1981 are incorporated in S. 2479. There are, however, technical differences between our recommendations and the provisions of S. 2479. We believe it may be helpful to outline the major areas where substantive changes are suggested by both the Tax Section and S. 2479 and also to describe where differences in approach exist. One of the concerns which the Section of Taxation has with S. 2479 is the extreme length and complexity of the bill. We believe that in several areas the common objective of improved effectiveness of the estate tax deferral option can best be served by simplifying present law rather than by making it more complex.

Definition of "Interest in a Closely Held Business"

The Tax Section recommendation is that the various mechanical tests for determining when a "closely held business interest" exists, including the complex attribution rules related thereto, be eliminated and replaced by an exclusive nonmarketability test such as that now found in §6166(b)(7) of the Code applicable to non-readily-tradable stock. Under such a test, stock or partnership interests would qualify if, at the time of the decedent's death, there was no market on a stock exchange or in an over-the-counter market for such stock or partnership interest. Proprietorship interests would automatically qualify as under present law. It is believed that such a test would be simple to apply and simple for taxpayers to understand. Under that approach, pages 2 through 11 of the printed text of the S. 2479, pages which contain extremely complex attribution and other definitional rules, could be eliminated. In addition, the Tax Section approach would promote fairness in that an interest in a publicly traded corporation in which the decedent and members of his family owned 20% or more could not qualify as a closely held business interest as to which deferral would be permitted, whereas qualification under those circumstances would continue to be possible under S. 2479.

S. 2479 would permit notes to qualify as closely held business interests under certain conditions, as well as overriding royalty interests and assets leased to closely held businesses. Although an argument can be made for extending the closely held business interest definition to such assets, the administrative problems in such an extension, particularly in the acceleration area, appear formidable.

Aggregation of Closely Held Business Interests

Where a decedent's estate owns an interest in two or more closely held businesses the question arises whether and under what conditions these business interests may be aggregated in order to reach the 35% of adjusted gross estate threshold to qualify the estate for deferral treatment. After ERTA the rule is that the decedent's estate must own 20% or more of the value of each of such closely held business interest in order to permit them to be aggregated.

If the nonmarketability test proposed by the Tax Section were adopted, it would probably be desirable from an administrative standpoint to continue to require that a closely held business interest have some minimum value to be aggregated with other business interests to reach the 35% adjusted gross estate threshold. This would prevent the aggregation of numerous small interests, such as those which the decedent might hold in various tax shelter partnerships. The latest Tax Section recommendation did not recommend any change to the 20% aggregation rule. However, there would not appear to be any substantial administrative or fairness problem involved in using the test proposed by S. 2479, which would require only that each closely held business interest represent 5% or more of the adjusted gross estate. S. 2479 also permits certain smaller business interests to be aggregated, and this may create administrative problems.

Interest on Unpaid Installments

The Tax Section recommendation to solving the repetitive calculations required under present law to deal with interest on deferred estate tax payments where such interest is claimed as an estate tax deduction is to disallow the interest as an estate tax deduction, and in return therefor to establish a uniform interest rate on the deferred installments equal to one-half of the rate on deficiencies generally. This rate was suggested because at the 50% estate tax bracket our proposal produces the same revenue without the complex calculations. Arguments could be made for an even lower interest rate since Congress has always maintained a lower interest rate on deferred estate tax payments than on deficiencies generally. Furthermore, if the 4% rate portion which is allowable under present law were eliminated, this should equitably be translated into a lower overall rate. The question of the precise level of the interest rate is one which Congress is best able to decide, but the Tax Section does believe that the principle of a substantially lower rate in exchange for eliminating interest on deferred payments as an estate deduction is a sound principle which promotes fairness as well as simplification.

S. 2479 adopts an alternative approach to this problem, permitting an "up front" deduction based on the estimated interest expense which the estate might be expected to pay over the entire deferral period. This amount would be adjusted based on rules promulgated by Treasury Regulations. That procedure is substantially more complex than the Tax Section proposal, and may, indeed, be no less complex to use than the present rules. The S. 2479 approach will require adjustments to account for the difference between actual interest expense and estimated interest expense, even without acceleration events, which would require still further adjustments.

Acceleration of Payment of Deferred Taxes

One of the major technical problem areas in estate tax deferral is that of termination of the deferral privilege ("acceleration"). ERTA improved and simplified the acceleration provisions somewhat, but the Tax Section believes that further improvements are necessary.

One of the places where improvement is necessary is the redemption of stock or partnership interests from the estate in exchange for notes of the closely held business. The Tax Section drafted a legislative recommendation dealing with this subject, which in effect treats the obligations so exchanged as a substitute for the closely held business interest, so that no acceleration event would take place at the time of the exchange, but a subsequent disposition of the obligations might trigger acceleration. S. 2479 sets forth extremely detailed statutory rules to deal with this problem, covering 15 pages of printed text relating to §6166, and a similar number of pages relating to §6166A (for decedents dying before January 1, 1982 with respect to dispositions taking place after December 31, 1981). The Tax Section believes that the simpler statutory approach embodied in its legislative recommendation will better serve the administration of the tax laws even though it is somewhat less comprehensive in scope.

Another acceleration problem area where improvements were recommended by the Tax Section involves interaction with §303. Present law does not protect §303 redemption proceeds which are used to pay interest on deferred taxes and/or administration expenses. S. 2479 accomplishes this purpose, and also adopts the Tax Section recommendation that a disposition or withdrawal exists only of the excess of the amount of the §303 redemption over the amount used to pay taxes, interest and administration expenses. The bill also adds clarity to present law regarding the time when estate taxes and interest must be paid in coordination with §303 redemptions, and contains provisions designed to accord partnerships and proprietorships similar relief from operation of the acceleration provisions to that now available under §303 to corporate redemptions.

S. 2479 contains other provisions designed to foreclose accelerations where no substantial change in the character of the closely held business interest has taken place. These appear to be equitable provisions which should not create administrative complexities.

Judicial Resolution of §6166 Controversies

The Tax Section in its prior submission pointed out the need for a judicial forum to test §6166 qualification questions, as well as acceleration questions. S. 2479 addresses this problem by providing for a special Tax Court declaratory judgment procedure. The Tax Section recommendation was to treat §6166 qualification issues procedurally in the same manner that tax liability questions would be treated. Under that procedure, a personal representative who believes the estate is entitled to qualify under §6166 would take that position on the estate tax return; and, if the examining Revenue Agent should disagree, the matter would be dealt with via the normal administrative, and, if necessary, judicial channels, in the same manner as any other estate tax deficiency question.

The Tax Section proposal has the advantage of simplicity in that it builds upon the existing administrative and judicial structure, and avoids multiplicity of litigation. Under the Tax Court declaratory judgment procedure, on the other hand, irrespective of the resolution of the declaratory judgment question, the same estate may once again be in litigation on another issue, such as valuation. There is efficiency in litigating the deferral qualification question at the same time that estate tax liability questions are being litigated.

Retroactivity Issue

Several provisions of S. 2479 have application to the estates of decedents dying before January 1, 1982. The proposed acceleration rules would apply to determine whether post-1981 transactions involving estates of pre-1982 decedents constitute dispositions or withdrawals. Likewise, the judicial forum provisions of S. 2479 would be made applicable to acceleration questions arising from post-1981 transactions in the case of pre-1982 decedents. Further, under S. 2479 the estates of decedents dying before 1982 would be entitled to elect to deduct interest under the proposed new rule. The only estate tax provision of ERTA in this area affecting decedents dying before January 1, 1982 is the provision preventing acceleration upon the death of a transferee family member after December 31, 1981. The Tax Section does not generally favor retroactive provisions, and in the estate tax area effective dates are normally keyed to the date of the decedent's death.

II. S. 1983 - Disclaimer of Future Interests

I also wish to comment on behalf of the Section of Taxation on S. 1983, which provides a limited period for persons who hold a future interest in property created under a pre-November 15, 1958 instrument to disclaim that interest without transfer tax consequences. That bill will also allow disclaimers within nine months of the day the disclaimant had actual knowledge of the interest. The latter provision will lead to numerous lawsuits over a factual issue which is frequently difficult to determine and will be a great burden on taxpayers and the Government alike. The bill is designed generally to apply to a narrow group of individuals.

The Tax Section has previously considered this issue and concluded that as a matter of policy an effective disclaimer should be allowed,

> "in the case of any future interest in property not later than nine months after the event when the taker of the interest is finally ascertained and his interest has become indefeasible."

That position was endorsed by the American Bar Association in 1975, and we refer the Subcommittee's staff to Tax Section Recommendation No. 1974-2 (27 Tax Lawyer 818). Rather than this narrowly directed legislation, we urge adoption of a rule which reverses the Supreme Court in the recently-decided Jewett case and permits the holder of a future interest nine months after the interest has become indefeasible within which to disclaim. By definition, to constitute a qualified disclaimer the disclaimant may not have received actual benefits of the disclaimed property. Facing the issue in this manner is entirely consistent with § 2518 introduced by the 1976 Tax Act, as subsequently amended.

SUMMARY OF TESTIMONY
OF JOHN A. WALLACE
ON BEHALF OF
THE AMERICAN COLLEGE OF PROBATE COUNSEL
IN HEARINGS ON S. 2479 BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

May 27, 1982

The College urges that the rate of interest charged on estate tax payments that are deferred under Section 6166 should not be set by the same formula that establishes interest rates charged on tax obligations generally because of the policy considerations involved in the estate tax deferral area. Furthermore, in the view of the College the interest charged on such deferred estate tax payments should be reduced significantly from the inordinately high rates that now apply to most deferred estate tax payments. The College also recommends that interest incurred in connection with elective estate tax deferral should not be deductible for federal estate tax purposes, in order to simplify the mechanics of such deferral, but submits that this factor should be taken into account when the interest rate on such deferred payments is set.

Following a determination of the appropriate level for interest charges on deferred estate tax payments under Section 6166, the length of the deferral period under that statute should be reexamined, and, perhaps, reduced to some extent in order to arrive at an overall economic value for the deferral right that is fair and equitable to both taxpayers and the Treasury.

The College supports the use of a lack of marketability test to define the business interests that qualify for elective estate tax deferral. This approach would greatly simplify the existing statute and supplant a number of the proposed modifications to Section 6166 contained in S. 2479. In the view of the College this new test would also eliminate the arbitrary results often produced by the present definitional tests in the statute by limiting estate tax deferral relief to those situations where true illiquidity exists.

The College also urges that some form of judicial review be provided for disputes between taxpayers and the IRS in connection with estate tax deferral issues generally. The recommendation of the College in this area differs from most proposals currently pending before Congress and the proposal in this regard that is contained in S. 2479. The College believes that its proposal for treating the issue of judicial review of Section 6166 issues is fair to both taxpayers and the IRS, and will avoid unnecessary and costly litigation in many instances.

Finally, the College recommends several changes that are designed to eliminate technical problems that often impede the tandem use of Sections 6166 and 303 by executors. Other changes recommended by the College in this area will facilitate the use of buy/sell agreements for disposing of interests in closely-held businesses.

THE AMERICAN COLLEGE OF PROBATE COUNSEL IN HEARINGS ON S. 2479 BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION OF THE SENATE FINANCE COMMITTEE UNITED STATES SENATE

May 27, 1982

This statement has been prepared by the Estate and Gift Tax Committee of the American College of Probate Counsel (the "College"), and the positions presented have been specifically approved either by the Board of Regents or the Executive Committee of the Board of Regents of the College, and are submitted at the express direction of the President of the College, Rudolph O. Schwartz, Esq. of Manitowoc, Wisconsin. The membership of the Board of Regents and the Estate and Gift Tax Committee of the College is listed on Exhibit A of this statement.

The College is grateful for being given the opportunity to appear at this hearing and to express the views of our membership (which is composed of more than 2300 lawyers who specialize in the practice of trusts and estates law and related tax matters) concerning S. 2479, the Section 6166 Technical Revision Act of 1982. The improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximum extent possible the disposition of property and the administration of estates in this country, has been a major and continuing goal of the College from the date it was first organized more than 30 years ago. There is no doubt that our estate and gift tax laws represent the most complex and expensive aspect of our system of property disposition, and we welcome and accept once again the challenge of working with the present Congress to find ways of improving and simplifying these laws.

1. General Comments

S. 2479 focuses exclusively upon perceived deficiencies in Section 6166, the provision in the Internal Revenue Code of 1954 (the "Code") that allows an executor of an estate to defer the payment of the estate tax attributable to a defined closely-held business interest as a matter of right, and several related provisions of the Code. The executor's right to defer the payment of the estate tax attributable to such business interests has been an integral part of our transfer tax system since 1958. The members of the College can attest from their own experience to the need for some form of effective deferral to help closely-held businesses meet the heavy cost that is suddenly thrust upon the estate of a substantial owner of the business interest at death. For this reason the College has been dismayed that the economic value of this elective right has been curtailed to a significant extent in recent years. This curtailment is attributable, essentially, to two factors. First, the so-called "4% portion" of the estate tax that may be deferred under Section 6166, which enjoys a preferential interest rate, is being steadily diminished by increases in the unified credit. This occurs because Section 6601(j)(2) reduces the 4% portion by the amount of the allowable unified credit on a dollar-for-dollar basis, thus placing these two vital benefits for taxpayers in direct conflict with each other. Second, interest is now charged on the deferred estate tax in excess of the 4% portion at the rate of 20% annually. It is simply impossible for closely-held businesses to meet their normal operating capital needs and also pay the federal estate tax attributable to the interest of the deceased owner, if that tax is subject to interest charges at the present level.

The College believes that a number of amendments to Section 6166 are needed to remove inequities that now exist in that statutory provision. It is also the position of the College that the level of statutory relief extended to closely-held business interests under Section 6166 should be raised significantly in appropriate cases. From an overall standpoint, S. 2479 would improve the equitable character of Section 6166 by changing several rules and provisions that are arbitrary in their application, but it would be erroneous to contend that the modifications suggested for the statute as a whole promote tax simplification. For this reason, the College will focus attention on five separate areas impacted by the proposed changes in S. 2479. In some of these areas the changes suggested in S. 2479 have the support of the College. in others, the College suggests alternate proposals that it believes promote both the improvement of the statute from an equitable standpoint and also the concept of tax simplification.

2. Interest Rates and Interest Deduction

Present Law. The rate of interest charged on deferred estate tax payments is the same as the annual rate charged on tax obligations generally. At present, the annual rate is 20%, and this rate will continue to track commercial rates of interest under a formula in Section 6621(b) that relates to interest rates quoted by commercial banks to large businesses in the future. There is an exception to this general rule that provides a special 4% annual interest rate on a portion of the estate tax deferred under Section 6166, but, as noted previously, this portion of the estate tax is being steadily reduced by the increasing unified credit. I.R.C. § 6601(j)(2). As a result, to the extent interest charges are not attributable to the declining 4% portion of the deferred estate tax, the executor of the estate of an owner of a closely-held business is required to pay the same interest charges on deferred estate tax payments under Section 6166 that AT&T or

General Motors is required to pay on late payments or under payments of their taxes.

Interest paid on deferred estate tax installments is a deductible administration expense for estate tax purposes. Estate of Bahr v. Comm'r., 68 T.C. 74 (1977); Rev. Rul. 78-125, 1978-1 C.B. 292; Rev. Rul. 79-252, 1979-2 C.B. 333; Rev. Rul. 80-250, 1980-2 C.B. 278. The Internal Revenue Service (the "IRS") takes the position that this interest expense cannot be projected and deducted on the estate tax return by the executor because the various possibilities that might cause the deferred estate tax to be prepaid or accelerated, either voluntarily or involuntarily, makes any estimate of those projected expenses too vague and uncertain to be accrued under applicable rules in current Treasury regulations. Rev. Rul. 80-250, 1980-2 C.B. 278; Treas. Reg. § 20.2053-1(b)(3). As a result, the IRS insists that a supplemental Form 706 (federal estate tax return) must be filed with each annual installment payment. Rev. Proc. 81-27, 1981-27 I.R.B. 21. Each supplemental return (there may be as many as 14!) will reflect the payment of interest on the deferred tax for the year the return is filed, thereby increasing the amount of the administration expense deduction under Section 2053 and decreasing the amount of the estate tax liability. The reduction in the estate tax liability will, in turn, impact the amount of interest paid with each installment and cause a recalculation of the break-down in prior installment payments between tax and interest; in fact, a number of private letter rulings that treat this issue indicate that the IRS has developed its own computer program to deal with the complicated interdependent mathematical computations involved in this exercise.

Discussion and Recommendation. If a market rate of interest is not charged on late payments of taxes generally, taxpayers will naturally seek to borrow from the government at every turn by understating their tax liability or by paying their taxes as late as possible. As a result, the policy of tracking commercial interest rates for interest charges on late payments of tax generally is both understandable and necessary. It seems equally clear, however, that the same policy is totally inappropriate when it is applied to the determination of interest charges on deferred estate tax payments. In this latter case, tax policy encourages rather than discourages deferral. In short, the focus of interest rates in the estate tax deferral area is totally opposite from the focus of interest rates toward late payments of taxes generally. Yet, current law equates interest charges in each instance, with the exception of the preferential interest rate charged on the 4% portion of the deferred estate tax. The College believes that the interest rate charged on deferred estate tax payments should, as a matter of policy, be divorced from the interest rate charged on late tax payments. In addition, the College believes that a preferential interest rate should be applicable for deferred estate tax payments in keeping with the approach of Congress toward interest rates in this area between 1958, the date estate tax deferral as a matter of elective right was first authorized, and 1975, the date the interest rate on deferred estate tax payments was tied to the interest rate on late payments. The 20% interest currently charged on deferred estate tax payments is above market, with the result that estate tax deferral imposes an economic penalty on estates with closely-held business interests to the extent the deferred estate tax is not attributable to the special 4% portion. This result clearly runs contrary to the intent of Congress. The College believes that Congress is uniquely qualified to determine the level of relief that should be offered to executors electing estate tax deferral in terms of the level of interest charge levied, so we have no recommendation as to the particular rate of interest that ought to be assessed. We do, however, urge that the interest charge be set at a figure that can be relied upon for planning purposes and that the figure be set low enough to offer significant relief without encouraging abusive use of the deferral right by taxpayers.

The current position of the Internal Revenue Service toward the estate tax deduction for interest payments on deferred estate taxes is burdensome and completely unsympathetic. This statement should not imply that the College finds no foundation for the concern of the IRS about permitting an estimated administration expense deduction for anticipated interest payments on the deferred estate tax. The time for assessment of the federal estate tax expires three years after the estate tax return is filed, and the statute of limitations on the assessment of estate tax may not be extended by agreement. I.R.C. §§ 6501(a), 6501(c)(4). As a result, any reduction in the estate tax attributable to estimated interest payments on prepaid deferred estate tax installments cannot be recovered if the prepayment (which may be done without penalty) takes place after the statute of limitations has run on the time for assessment of the estate tax. The real issue is whether this prospect justifies the IRS position that estate tax deductions for payments of interest on deferred tax can only be claimed on a payment-by-payment basis.

While it appears that this problem could be resolved by imaginative use of one of several existing procedures that would also avoid the administrative burdens caused by the present IRS position, perhaps the simplest and best approach would be a statutory rule prohibiting an estate tax deduction for interest payments on deferred estate tax, provided, this factor is taken into account in lowering the interest rate charged on deferred estate tax payments. The prohibition against the deduction will simplify the mechanics involved in estate tax deferral elections greatly. The economic burden that attaches to this simplification effort, i.e., the loss of the deduction, should not, however, be passed along to the estate; rather it should be reflected in a sharply reduced interest charge on the deferred tax installments.

3. Deferral Period

Present Law. Section 6166 now permits electing executors to defer the payment of the federal estate tax liability attributable to an interest in a closely-held business over a period of 14 years following the due date for the federal estate tax return. In addition, the executor may also elect to pay only interest during the first five years of this deferral period.

Discussion and Recommendation. The economic value of an estate tax deferral right is comprised of two components, the amount of interest charged on the deferred liability and the length of time for payment of the tax. At present, the deferral period is quite lengthy, and the interest charges are exorbitant. The College has recommended a sharply reduced interest charge on deferred estate tax payments; in turn, we admit it might be appropriate to examine the question of whether the present deferral period is too lengthy. A reduction in the time frame for deferral, coupled with a reduction in the interest rate charged on the deferred estate tax liability, seems fair.

4. Closely-Held Business Interest

Present Law. The statutory definition of an interest in a closely-held business that gives rise to an estate tax deferral right is exceedingly complicated. First, the business entity in question must carry on a trade or business. Unfortunately, there is no definition of the term trade or business in the statute, the Treasury regulations thereunder, or decided cases. As a result, the responsibility for determining whether the entity is carrying on a trade or business for estate tax deferral purposes is left with the IRS. This opens the door for curtailment of statutory relief by an administrative decision that the trade or business standard has not been met in a given case. This is completely one-sided and unsatisfactory since, as will be discussed later, an IRS determination to this effect is not subject to judicial review.

On the other hand, the closely-held aspect of the statutory definition of an interest in a closely-held business is based upon objective criteria. The question of whether a business interest is closely-held is dependant upon the number of persons with an interest in the entity or the percentage interest of the decedent in the entity. For example, a corporation or partnership is closely-held if (i) there are 15 or fewer stockholders or partners or (ii) the decedent held 20% or more of the voting stock in the corporation or the capital interest in the partnership. These qualification tests are complicated further by the application of family, spousal and entity attribution rules as well as aggregation rules that permit separate business interests to be consolidated under certain circumstances. All of these rules can produce bizarre results. For instance, a corporation with 16 unrelated stockholders will not qualify as a closely-held business even though the stock in question obviously has no public market. On the other hand, a block of stock representing 20% or more in value of the voting stock of a corporation listed on the New York Stock Exchange can qualify as an interest in a closely-held business. Definitional rules that produce such results are, or should be, automatically suspect. Moreover, it is difficult to keep these objective tests up to date. For example,, the present numerical test deems an interest in a closely-held business to qualify for estate tax deferral if (with the application of the attribution rules noted previously) there are 15 or fewer partners or stockholders. S. 2479 recommends that this number be increased to 25 in order to reflect the historical relationship between the definition of an interest in a closely-held business under Section 6166 and the definition of a corporation allowed to elect Subchapter S treatment under Section 1372. It is interesting to note that S. 2350, the Subchapter S Revision Act of 1982, currently pending before this Committee, will authorize a corporation with 35 or fewer stockholders to elect Subchapter S treatment.

The College believes that the substitution of an exclusive nonmarketability test, similar to the "non-readily-tradable stock" test in Section 6166(b)(7), for the present statutory definition of an interest in a closely-held business would avoid the arbitrary results produced by the present definitional tests and simplify the provisions of Section 6166 substantially. The use of a test based upon the presence or absence of actual marketability would limit the deferral election to situations where true illiquidity exists. This completely new approach would also avoid numerous issues that are raised by the current definition of an interest in a closely-held business for purposes of the statute and are dealt with in S. 2479. Finally, this test could be applied without administrative difficulty, provided that Congress also provides some objective rules that define exactly what constitutes carrying on a trade or business for purposes of Section 6166.

5. Judicial Review

Present Law. Adverse action by the IRS with respect either to the availability of elective estate tax deferral or the mechanics of working with deferral is particularly troublesome because taxpayers have no apparent recourse to judicial review in this area. Disputes between taxpayers and the IRS in connection with estate tax deferral issues generally relate solely to the timing of estate tax payments rather than the amount of the actual estate tax liability. As a result, the lack of a controversy with respect to the actual tax forecloses Tax Court jurisdiction, since that jurisdiction is predicated, pursuant to Section 6213(a), upon a redetermination of a deficiency. Section 6211 defines a deficiency in terms of a controversy between the taxpayer and the Internal Revenue Service as to the *amount* of tax that is due.

Similar jurisdictional problems are encountered if the taxpayer attempts to take a disputed estate tax deferral issue to the District Court or the Court of Claims. Each of these forums requires a denial of a claim for refund of tax alleged to have been erroneously or illegally assessed or collected as a condition precedent to the lawsuit. If an extension of time for the payment of estate tax is denied, or the taxpayer is forced to prepay the estate tax, the taxpayer must pay an agreed upon estate tax in any event. Here again, the fact that the controversy involves the timing of the tax payment rather than the amount of the actual tax operates to deny the taxpayer access to these tribunals.

A decision by an executor to elect estate tax deferral under Section 6166 may also inhibit the executor's strategy in pursuing claims for refund on behalf of the estate. In Flora v. United States, 360 U.S. 145 (1960), the Supreme Court held that refund suits cannot be filed unless the tax involved has been paid in full. This raises the issue of the jurisdiction of the District Courts or the Court of Claims with respect to refund suits for estate tax when there remain unpaid but properly deferred estate tax payments. At the moment the Tax Division of the Department of Justice, with the concurrence of the Chief Counsel of the Internal Revenue Service, takes the position that the government will not assert the Flora defense in an estate tax refund suit where there is an outstanding election under Section 6166, so long as the issues raised in the refund suit appear to constitute bona fide contentions. Even so, the Flora doctrine continues to cast a pall over refund suits by an executor while there is an outstanding election, because administrative agencies of the government can change their minds about trial tactics and also because the government may take the position that the executor's refund suit is not based upon bona fide contentions.

Discussion and Recommendation. Basic fairness mandates some appropriate form of judicial review for disputes between taxpayers and the IRS over Section 6166 issues. The approach adopted should, however, attempt to ameliorate to the maximum extent possible audit problems for the IRS. Unfortunately, pending statutory proposals in these areas fall somewhat short of fulfilling these two objectives. For example, the prevailing view seems to be that a declaratory judgment procedure should be enacted to provide a forum for resolution of disputes under Section 6166. Last year, during the development of the Economic Recovery Tax Act of 1981, the House passed H.R. 4242, which contained a provision that would have allowed taxpayers to challenge adverse IRS determinations in the elective estate tax deferral area through an unreviewable declaratory judgment proceeding in the Tax Court. This provision was subsequently eliminated in conference. Thereafter, S. 1733 was introduced in the Senate to provide a Tax Court declaratory judgment procedure for the following issues: (1) whether an estate is eligible for installment payment of estate taxes, (2) the amount of the adjusted gross estate, and (3) whether an acceleration event requiring prepayment of the deferred tax has occurred. This bill was added by Senate floor action on December 16, 1981 to H.R. 4717, a miscellaneous tax bill passed by the House the previous day. As passed by the Senate, the decision of the Tax Court on these declaratory judgment matters is deemed conclusive and is unreviewable; judicial review itself is also subject to a determination by the Tax Court that the executor has exhausted all available administrative remedies prior to filing the petition for declaratory judgment. S. 2479 would allow a similar proceeding, except the decision of the Tax Court would be reviewable by the Courts of Appeal like any other case.

While the prevailing view seems to be that a declaratory judgment procedure should be enacted to provide a forum for resolution of disputes under Section 6166, the College is concerned that a judicial proceeding of this type will anticipate the most critical audit issues for estates with an interest in a closely-held business. For instance, eligibility for elective estate tax deferral necessarily involves the key valuation issues that would normally be taken up on audit, such as the value of the closely-held business interest and the value of the adjusted gross estate. Any judicial proceeding that considers the eligibility of an estate for elective deferral must therefore either preempt the normal audit process or precipitate an early audit of the estate. In either case judicial review will present timing and administrative problems for the IRS. On the other hand, eligiblity for elective deferral may be of critical importance to the estate, and this need may well outweigh the administrative inconvenience suffered by the IRS in such cases.

We suggest a simple solution to this problem. We feel that a better overall balance of the interests of the IRS and taxpayers might be achieved by a rule that allows an electing executor to continue to rely upon a deferral election even though the IRS disputes the executor's right to make the election until that issue, along with all other issues, is taken up in due course on audit. Thereafter, if there is a dispute between the IRS and the executor on the election issue, the disagreement could be resolved, like any other issue giving rise to a deficiency, through the courts. This approach would seem to preserve the rights of taxpayers with respect to elective deferral without causing undue hardship for the IRS from an administrative standpoint. Hopefully, the usual give and take between taxpayers and the IRS on audit will avoid litigation over Section 6166 disputes, another point that supports the College's position on this particular issue. The definition of a deficiency for Tax Court proceedings would have to be modified to enable the Tax Court to accept disputed Section 6166 cases. A similar statutory amendment would be required to enable executors to seek redress in the District Courts and the Court of Claims if this suggestion is adopted.

The further problem of lack of access to the courts posed by the possible application of the Flora doctrine should likewise be resolved by statutory amendment. The Section of Taxation of the American Bar Association has recommended that an estate electing deferred payment of estate taxes be permitted to file claims for abatement of erroneously assessed estate taxes within three years from the date of filing the return or within two years from the date of assessment, whichever is later, in order to resolve the problem posed by the full payment defense. This recommendation is described in detail in 34 *The Tax Lawyer* 1414 (1981). The College feels that this recommendation is an appropriate solution for this problem, and endorses the recommendation of the Section of Taxation.

6. Selected Acceleration Issues

Present Law. Tax deferral is not always assured under Section 6166, even though the estate is able to satisfy the various statutory qualification requirements and the executor files a timely election to pay the estate tax attributable to the decedent's closely-held business interest in installments. There are three instances in which subsequent activities on the part of the executor or others during the period of administration will require an immediate payment of part or all of the remaining unpaid estate tax installments. The acceleration rules governing those activities are set forth in Section 6166(g) and include, as acceleration events, an unreasonable accumulation of income in the estate following the interest-only deferral period, a failure to make a timely payment of tax or interest, and an unreasonable withdrawal of funds from the business or a disposition of a substantial portion of the decedent's interest in the business.

The importance of these acceleration rules should not be underestimated. With the exception of the undistributed net income rule, the acceleration penalty provisions often operate on an all-or-nothing basis. In other words, the slightest mistake in the calculation of the amount of the closely-held business interest that may be redeemed or disposed of by the executor will automatically trigger all remaining estate tax payments. Moreover, the regulations require the executor to notify the District Director within 30 days after receiving knowledge of the redemption or disposition transaction that violates this acceleration rule. The District Director is obliged to issue a notice immediately thereafter that the total amount of the deferred tax is due and demand payment. These procedures leave absolutely no leeway for corrective measures in the event an acceleration transaction takes place, with the result that the executor must take great care to avoid acceleration events if continued estate tax deferral is important to the estate administration.

The acceleration provisions were improved considerably by the Economic Recovery Tax Act of 1981. The Act combined the withdrawal and disposition rules, provided additional exceptions for transfers of closely-held business interests following the death of the business owner, and enacted a grace period for a failure to make a timely payment of interest or a tax installment. Nevertheless, the acceleration rules continue to pose several problems for taxpayers that should be addressed at this time.

Discussion and Recommendation. In many instances the interest of the decedent in a closely-held business is subject to a buy/sell agreement because the stockholders or partners naturally wish to restrict the transferability of interests in the business to others. If the interest of the decedent is acquired by the business or by the other owners, whether through a prearranged buy/sell agreement or otherwise, and a significant part of the purchase price is paid over time (as will frequently be the case), the estate will be unable to defer the payment of the estate tax attributable to the business interest, or, if deferral has been elected, the disposition and withdrawal rule will accelerate the unpaid estate tax. This occurs even though the notes received by the estate from the business or the other owners are, as a practical matter, no more liquid than the business interest owned by the decedent. The disposition and withdrawal acceleration rule should not discourage buy/sell arrangements for a closely-held business interest in this manner. Again, the Section of Taxation of the American Bar Association has recommended that obligations received by the estate in transactions of this type should be substituted for the stock or partnership interest exchanged in the transaction. This recommendation is described in detail in 32 The Tax Lawyer 1464 (1979), and is endorsed by the College. The College would also support a rule that qualifies indebtedness of a closely-held business owned by the decedent for deferral initially, since there is no logical policy reason for treating debt and equity differently for estate tax deferral purposes.

There is an exception to the withdrawal and disposition acceleration rule that exempts transfers of the decedent's interest in a closely-held business by reason of death to family members (as defined in Section 267(c)(4)). S. 2479 would expand this exception further to exempt transfers to persons other than family members by reason of death. We do not support this change. This proposed expansion would not, in the view of the College, fall within the basic policy design of Section 6166, which is to allow closely-held businesses to remain under family control. The College would, however, support an expansion of this exception to exempt transfers of the decedent's business interest to other family members that occur for reasons other than the death of the decedent from the withdrawal and disposition acceleration rule.

There is a close correlation between Sections 303 and 6166 because estates with substantial ownership interests in closely-held corporations must often have recourse to the corporate property for estate liquidity needs. The necessity for tandem use of these statutory provisions has long been recognized by Congress, and amendments to both statutes enacted by the Economic Recovery Tax Act of 1981 have now resulted in a complete correlation between the qualification tests for the estate tax deferral election and protected redemptions. Unfortunately, the application of the withdrawal and disposition acceleration rule in Section 6166, and rules relating to the timing and use of protected redemptions under Section 303 often prevent these statutory provisions from coinciding with each other in practice. This unfortunate situation would be cured in large part by amending Section 6166 to provide that stock redemptions that are protected under Section 303 cannot trigger the withdrawal and disposition acceleration rule so long as the redemption proceeds are used to pay state death taxes or expenses of administration as well as federal estate taxes.

7. Summary

There have been major changes in our federal estate and gift tax laws in recent years, particularly in 1976, 1978 and 1981. On each occasion Congress has modified the federal estate tax deferral election rules significantly. Even so, Congress, the Treasury and taxpayers alike all seem to be unhappy with elective estate tax deferral in its present form. Over the past several years Congress has imposed increasingly heavy interest charges on deferred estate tax payments. As a result, the economic value of deferral has been reduced dramatically; in fact, an observer can now only wonder why so much furor is being generated over a relief provision that offers so little relief. In turn, recent rulings by the Internal Revenue Service in situations involving the trade or business standard in Section 6166 or the treatment of interest payments on deferred estate tax installments as administration expenses indicate a general antagonism toward the concept of deferral and a willingness to foreclose taxpayer access to elective deferral whenever possible. Finally, the volume of pending amendments to Section 6166 proposed by taxpayers and their representatives (dramatically highlighted by the length and breadth of the changes contained in S. 2479) provides convincing proof that the private sector is both dissatisfied with and concerned about the present deferral system.

The question of the proper interest charge for estate tax deferral is particularly troublesome. The current rate is simply too high. Nevertheless, Congress has always seemed reluctant to allow taxpayers to defer the estate tax liability if there is any prospect at all that the cash that otherwise might have been used to pay the deferred tax can be invested at very high rates. There is a policy issue here, namely, whether the interest charged on deferred estate tax should be equated with the interest charged on tax obligations generally. If the interest charged in the latter situations is below market, taxpayers will naturally borrow from the government either by delaying the payment of their taxes or by calculating their tax liability as low as possible. Is the same concern really applicable to a carefully designed deferral right that is based upon an economic hardship? The value of a reduced interest rate on deferred estate tax installments increases with the length of the deferral period. Perhaps the best compromise would be a reduction in the rate of interest and also in the time of deferral; administrative simplification would also be achieved if the interest payments were made nondeductible, but this fact should be reflected in the reduced interest rate selected by Congress. In any event, some breakthrough is urgently needed in this area. In addition, the need to provide judicial review for estate tax deferral issues and the desirability of a statutory definition for the trade or business standard under Section 6166 call for additional statutory change. Finally, appropriate statutory modifications should be considered to provide a better coordination between Sections 303 and 6166, which have long been considered as compatible provisions but which still do not coordinate very well in actual operation with each other, and to facilitate buy/sell agreements that contemplate deferred payment of the purchase price.

STATEMENT OF
DONALD W. THURMOND
ON
BEHALF OF
AMERICAN BANKERS ASSOCIATION
STATEMENT ON S.2479

This statement is filed on behalf of the American Bankers Association (ABA) in general support of S.2479 which if enacted would broaden the application of sections 6166 and 303 for decedents' estates containing interests in closely-held businesses. The ABA is a trade association composed of more than 13,000 banks, approximately 4,000 of which are authorized to act as executors and trustees. Accordingly, our association has a significant interest in decedents' estates and closely-held business interests and our members have considerable experience in the planning and administration of estates with such interests.

The ABA has been concerned for several years with the operation of section 6166, granting an extension of time to pay the federal estate tax attributable to closely-held business interests, and related areas. An ABA memorandum dated August 27, 1980 made recommendations for change. For the record, we are attaching to this statement a copy of this memorandum and are pleased to note that some of our recommendations have been included in S.2479. Our comments will be limited to clarifications or changes which we believe would improve S.2479 and several suggestions for additions to the bill which were recommended in our August 27, 1980 memorandum but are not covered by the bill.

Allowance of Interest on Deferred Tax as Administration Expense Under Section 2053

Under existing policy, the IRS will allow interest on estate tax deferred by section 6166 as an administration expense deduction under section 2053 only after the interest is actually paid. This requirement causes considerable complexity in the operation of section 6166 and in certain cases hardship in its application. For example, in computing the amount of the estate tax marital deduction an estimated amount for all interest payments during the deferral period must be reflected and can reduce the deduction. The result can be an "overpayment" of estate tax when either the interest deduction or the marital deduction will eliminate the overpayment because the interest is allowed as a deduction only as paid.

The bill would eliminate some complexity by (i) changing the interest rate on the deferred tax (except to the extent the four percent rate is applicable) to a "qualified rate", which is defined as the rate equal to the average yield to maturity of United States obligations that mature during December of the calendar year 13 years after the calendar year of the decedent's death rounded to the nearest full percentage point and (ii) permitting an estate tax deduction when the return is filed for the interest covering the entire deferral period based upon the qualified rate. If the estate terminates its deferral privilege early, the decedent's taxable estate would be adjusted to reflect a reduction in the amount of interest deducted under section 2053. The statute of limitations would remain open on the estate tax during the deferral period granted in order to permit the adjustment to be made. The estate would then pay any additional tax plus interest at the normal rate on the underpayment. We assume this interest would be available as a deduction to offset the reduction for the interest that will not be paid.

The ability to claim an estate tax deduction for estimated interest payments during the entire deferral period is of substantial benefit to an estate. No discount would be required to reflect the fact that the payments are not due when the estate tax return is filed. While this result is consistent with the allowance of a deduction for attorneys' fees and executors' commissions, which are not discounted for future payment, the significance of the interest deduction is considerably greater because the interest payments are much larger. As a result of the "up front" estate tax deduction for the interest, this deduction tends to be more beneficial than an income tax deduction for the interest which is available only when the interest is paid.

While the proposed approach would be an improvement over existing law, we believe that either (i) this approach should be refined in certain respects or (ii) a simpler approach should be used which is discussed below. The qualified rate concept is retained with the suggested simpler approach. This concept, which establishes certainty concerning the rate of interest to be paid, is a substantial improvement over current law with its fluctuating rate which makes long range planning difficult.

A. Marital Deduction Increase

A problem exists in cases where the interest paid has the effect of decreasing the marital deduction. This will most frequently occur when the estate pays an estate tax because the applicable state death tax law does not contain a marital deduction conforming to the federal law. Revenue Ruling 82-6, IRB 1982-1 at 16, holds that when an estate elects to defer the payment of estate tax under section 6166 the amount of the estate tax charitable deduction for a residuary bequest is determined by reducing the residuary estate by an estimate of the maximum amount of interest that will be payable on the deferred tax whether the interest is deducted on the estate tax return or on the estate's income tax returns. The result should be the same when a marital deduction bequest is charged with the interest, which will always occur when the state death tax exceeds the amount protected from tax by the credit shelter. In this case the interest deduction does not reduce the estate tax, but rather reduces the marital deduction.

Let us assume that an estate claims a marital deduction based upon Revenue Ruling 82-6 and later the estate pays the deferred tax early. Under the approach of S.2479 may the estate claim an increased marital deduction to offset the reduced interest deduction under section 2053? The offset should be permitted provided the increased amount passes to the surviving spouse. Proposed section 2053(e)(2) - lines 18 through 25 on page 51 - should be revised to state that an increased marital deduction may be claimed for additional property passing to the surviving spouse.

B. Application of 35% Requirement

Under existing IRS practice, interest on deferred estate tax which is deductible under section 2053 cannot be taken into account in determining whether the estate meets the 35 percent qualification requirement under section 6166 - the closely-held business interest must equal 35 percent of the adjusted gross estate as defined in section 6166(b)(6), viz., the gross estate reduced by the "allowable" section 2053 and 2054 deductions because of the last sentence of section 6166(b)(6) stating that

> "Such sum shall be determined on the basis of the facts and circumstances in existence on the date (including extensions) for filing the return of tax imposed by section 2001 (or, if earlier, the date on which such return is filed)."

We are uncertain whether this result is to be changed by proposed section 2053(e) and suggest that S.2479 should deal with this issue specifically by amending section 6166(b)(6) to state that the interest deducted under section 2053(e) when the return is filed shall or shall not be taken into account. If the decision is to take interest into account, section 6166(b)(6) should refer to the interest on the return as filed so that an election to terminate the deferral privilege, with any resulting change in the interest deduction, would not cause the initial election to have been invalid because the qualification requirement was not met.

C. Amount of Deferred Tax

The clarification suggested in the preceding paragraph also has significance in terms of section 6166(a)(2) which limits the amount of deferred estate tax (after credits) by a fraction having a numerator equal to the value of the closely-held business interest and a denominator equal to the adjusted gross estate. An acceleration of the payment of estate tax, which would cause the fraction to become smaller should not have any effect on the amount of the tax eligible for deferral under section 6166(a)(2) with respect to amounts previously paid.

D. Use of Normal Rate on Early Payment of Deferred Tax

If the current interest rate is significantly below the qualified rate the executor must consider the termination of the deferral assuming funds are or may be made available to pay all or part of the remaining tax. Termination may cause interest to be paid at the normal rate on the amount of the net interest deduction decrease - the interest reduction less the deduction for the additional interest paid. In rare cases the result may be an increase rather than a decrease in the deduction. Will the estate be entitled to a refund plus interest in such a case? We believe a better approach would be to use the qualified rate rather than the normal rate in determining the interest payable on any additional estate tax resulting from any termination of the deferral.

E. Simpler Approach

The report of the Task Force on the Technical Revision of Section 6166 in discussing a solution to interest as an administration expense mentioned eliminating interest as a deduction under section 2053 and reducing the interest rate payable on the deferred tax to fifty percent. The ABA believes this general approach is preferable to the one in S.2479 and suggests the following:

1. Interest on any deferred estate tax, whether under section 6166, under state law or otherwise, under a state law would not be deductible under section 2053.

2. The qualified rate would be determined as under S. 2479.

3. The interest rate payable would be the qualified rate times the reciprocal of the highest estate tax rate applicable at the time of the decedent's death. Thus for a decedent dying in 1983 when the highest estate tax rate is 60%, the reciprocal would be 40% which would be multiplied by the 4% rate or qualified rate to determine the interest rate payable.

4. If desired, interest could be made nondeductible for income tax purposes or the estate could be permitted to pay the full 4% or qualified rate and claim the interest deduction for income tax purposes. On

balance and for simplicity, we favor making the interest non-deductible for income tax purposes. Should interest be retained as an income tax deduction, we recommend that interest on estate tax, whether federal or state not be treated as an adjusted itemized deduction for the purpose of the alternative minimum tax.

The loss to the federal fisc from the suggested approach should be less than under S.2479 with its "up front" estate tax deduction, particularly when the top rate of estate tax becomes 50% and the maximum estate tax rate spread becomes 13% and only 9% for taxable estates above $1 million. Also, the suggested approach would avoid the interdependent computations of estate tax and interest that are required under S.2479 and current law.

Acceleration of Deferred Tax

A. Trust's Included in Gross Estate

Section 3 of S.2479 contains changes that would eliminate acceleration of deferred estate tax payments in certain situations. In general, section 6166(g) provides that acceleration shall occur if one-third or more in value of an interest in a closely-held business is "distributed, sold, exchanged or otherwise disposed of". An exception is created by section 6166(g)(1)(D) for

> "a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive

> such property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent" (emphasis added).

This exception would not apply if the trust was created by another person but included in the decedent's gross estate, as is the case with a marital deduction trust. In our opinion no policy reason exists for this result. Trust property included in a decedent's gross estate should be treated in the same manner as property passing under the decedent's will for purposes of acceleration. The words "a trust created by the decedent" should be changed to "a trust included in the decedent's gross estate". The problem is not solved by the change made by S.2479 in section 6166(g)(1)(D). See lines 19-24 on page 18 and lines 1-5 on page 19.

B. Undistributed Net Income

Section 6166(g)(2) provides that if an "estate" has undistributed net income for any taxable year ending on or after the due date of the first installment the executor shall on or before the date for filing the return for such year pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the deferred tax. Undistributed net income is distributable net income of the estate less (i) the amount of the distribution deduction under section 661, (ii) the estate's income tax and (iii) the estate tax (plus interest) paid by the executor during such year.

In discussing section 6166(g)(2) our memorandum states:

> These provisions create untenable distinctions depending upon what disposition is made of property included in a decedent's gross estate. The undistributed net income rule applies to income on property included in the probate estate but not to income on property included in a revocable trust created by the decedent or to income on property forming a part of a trust created by another person or an irrevocable trust created by the decedent. Thus, the rule is meaningless as to non-probate property.
>
> Also, the rule is of limited significance for probate property. Interest on the deferred tax paid during a particular year reduces the "undistributed net income" at least once, or twice to the extent interest on the deferred tax is claimed as an income tax deduction and thereby reduces the estate's distributable net income. Why should the application of the rule vary depending upon whether this interest is claimed as an income tax deduction or an estate tax deduction and why should "double dipping" be permitted?
>
> Some states follow the federal lead and permit the state death tax attributable to a closely-held business to be deferred and paid in installments. See e.g., N.Y. Tax Law §962(f); Wis. Stat. Ann. §72.22(4)(a). In such situations, a distinction should not be made between the federal and state tax for purposes of the undistributed net income rule and, in addition, use of the income to pay the state income tax should not be "penalized".
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> To summarize, in its present form the undistributed net income rule is unsound. It should be modified to meet the points mentioned above or, preferably, be eliminated.

We continue to believe section 6166(g)(2) should be modified or stricken.

Senator **Symms**. Is it your suggestion on the interest rate, on what you pay then, is to go for half of the prime rate?

Mr. **Thurmond**. No; we would take the qualified interest rate concept that is in S. 2479. And then we would halve that and make that the interest liability.

We believe that the statutory language is really very, very complicated and that that could be eliminated by in effect using a marketability test.

With respect to interest, the difficulty that we have with the approach in the bill is that it is going to require constant adjustment by the Treasury for the difference between the estimated deduction and the actual interest expense.

We believe that a fair method, both for the taxpayer and for the Government, is to eliminate it as a deduction but just to reduce the rate approximately 50 percent, which is the maximum value that it would have to any estate.

Senator **Symms**. Well, I don't really disagree that the bill is a little bit too complicated. I think I have an answer for that in another bill I have introduced which would take care of the whole problem. But I think, in view of the budget deficit, it is going to be a while before we actually get that done.

But I appreciate your input, and we will take all of the testimony of all four of you. I do appreciate your help on this. We will have the committee staff very carefully go through that, because it would not be my intention to try to make the law any more complicated. We would like to make it more simple; but it is a very complex law in the first place, as you all are very well aware of.

So we will definitely look at those recommendations, and I thank you all very much.

Panel members: Thank you.

Senator **Symms**. Our next panel consists of Reiter Webb, consultant, National Cotton Council of America; Thomas Davis of Davis and McLeod, Washington, D.C., on behalf of the National Cattlemen's Association in Denver, Colo.; and Donald Kelly, from Nebraska, also.

So, come on up, gentlemen.

I can't help but notice all of you tax lawyers in the committee room. Every time I talk about one of my simplifying tax amendments, you smile and shudder and say "Thank heavens he doesn't have the votes," you know.

But our day is coming when we are going to get rid of the death tax.

Mr. Webb, do you want to start out?

STATEMENT OF H. REITER WEBB, JR., CONSULTANT, NATIONAL COTTON COUNCIL OF AMERICA, WASHINGTON, D.C.

Mr. **Webb**. Thank you, Mr. Chairman.

I am appearing here today before the subcommittee as Washington attorney for the National Cotton Council of America. As I'm sure you know, the council represents all segments of the U.S. cotton industry, including producers, ginners, warehousemen, merchants, textile mills, cooperatives, and the cottonseed crushing industry.

Since the chairman is trying to save time, I am going to skip a few parts of my written statement, because they have been adequately covered by other speakers, and try to concentrate on the things that we see are of particular concern to agriculture, and especially the economic impact. My comments are much more concerned with that subject than on the technicalities of administration.

As others have said, one of the prime purposes of section 6166 is to allow the owners of closely held businesses, including farms, to pay estate taxes in installments rather than at once, so that these family businesses and farms will not have to be sold in order to pay taxes.

We believe that policy made sense when section 6166 was enacted, and we believe it makes sense today. However, when the present section 6166 was enacted in 1976 we lived in an entirely different economic world and were looking at interest rates of 7 and 6 percent.

Legislation enacted in 1975 changed the interest rate payable on deferred estate taxes from a flat rate fixed by statute to a rate determined by a formula related to the prime rate. The first rate computed under this formula effected in 1976 was 7 percent, and in 1978 the formula rate became 6 percent.

As Mr. Wallace mentioned a few moments ago, the application of the formula today results in an astounding 20-percent interest rate being paid on deferred estate taxes, a rate which was certainly not contemplated when section 6166 was enacted.

Together with 2 consecutive years when cotton farmers generally have lost money and very uncertain prospects for significant recovery in 1982–83, the 20-percent interest rate presents the heirs with an almost insurmountable cash flow problem. Indeed, any time interest rates are high, heirs are usually faced with the extra interest on the deferred tax at the very time they are suffering from high operating costs and depressed markets.

The chairman may have seen the story in yesterday's Wall Street Journal with the headline "Wave of Farm Foreclosures Feared As Big Debt and Low Income Takes its Toll."

High interest rates nearly always result in economic stagnation because of inventory reduction all through the marketing chain as well as more modest consumer purchases.

In the absence of some change in section 6166, the solution might appear to be the sale of enough land to pay off the estate tax in full, since the sale of small blocks of land to pay annual interest is usually not feasible in agricultural areas. However, today's difficult financial conditions almost certainly rule this out as a solution. In the first place, it would be virtually impossible to find a buyer willing and able to pay cash for the land. It is much more likely that a buyer would want to make only a minimum down payment and the seller would be forced to carry paper for the balance.

While interest rates are still far above levels which we've always before considered normal, they are well below the 20 percent being charged under the statute on deferred estate taxes. Furthermore, sellers of land and other real estate are finding it increasingly necessary to engage in so-called creative financing at interest rates lower than current levels in order to make a sale. In other words, the interest earned on that part of the sale being financed by the seller would be substantially lower than the 20-percent interest being paid on the deferred estate tax. Consequently, it would probably be necessary to sell a substantial portion of the total farm in order to realize enough cash to pay the estate tax, plus any capital gains tax that might be due on the sale. This is a sale which could change the basic nature and efficiency of the farm unit to the point where the best alternative might well be to sell the entire farm—the very result section 6166 is intended to prevent.

Another major problem in trying to sell enough land to pay off the estate tax in full is that of the underlying mortgages. In many cases these would be at interest rates substantially lower than those of today, and they may be "due on sale." Obviously, the lenders under those mortgages are not going to allow them to be assumed at the old rates. The heirs would again be faced with painful alternatives: If they are forced to pay off the old mortgages and refinance the property at today's interest rates, the higher mortgage payments could easily make the entire farming operation unprofitable. If the sales proceeds were used to pay off the old mortgages as well as to pay the estate tax, it is highly likely that there would not be enough land or money remaining to continue in operation as a viable farming unit.

Last year the task force was formed to lend their expert knowledge, and they made four specific recommendations. The Council is happy to support all four of them. They have been mentioned, but I will very quickly cover them: The interest arising from the deferral of estate taxes should continue to be deductible as an administrative expense; the rates should be geared to the then-prevailing yield on Treasury obligations of comparable maturity; all of the interest payable, including interest imposed by a State, would be deductible when the return was filed; and, important to many of our members, while the changes proposed above would generally apply to decedents dying after December 31, 1981, a transition rule covering decedents dying before January 1, 1982, would permit such estates to utilize the new interest-rate deduction provisions for the post-1981 payout period.

Finally, Mr. Chairman, we believe that these changes are very necessary in the interest of fairness—fairness between the estates of decedents with closely held businesses who died before January 1 of this year and those dying thereafter.

Since executors can elect to defer estate taxes for as long as 14 years, it is important to compare the tax situation that will be faced by the estates of decedents who come under the provisions of last year's Economic Recovery Tax Act and those of decedents who died earlier since many of those who died earlier will still be paying estate taxes and interest long after the more liberal provisions of last year's act are fully phased in during 1985. Obviously, the estates of those dying before January 1 of this year will face a continuing long-term cost disadvantage far into the future compared with those covered by last year's Tax Act.

We believe the recommendations of the task force are fair and will tend to equalize these two situations.

Thank you very much, Mr. Chairman.

Senator SYMMS. Thank you very much.

I have just one quick question. In the case of many of these farms, if they are forced to liquidate the farm to pay it off, who ends up buying? Foreign investors?

Mr. **Webb**. Foreign investors, large corporations; very seldom in today's market would it be local people.

Senator **Symms**. What you are really saying is a tribute, I guess, to the difficult economic times if the farmer can't afford to pay for 20 percent or 30 percent of the value of his farm and still operate it while paying 20 percent interest.

Mr. **Webb**. And particularly when he is losing money.

Senator **Symms**. And, of course, there are many of them out there that owe a large amount of the equity of their farms that are exactly trying to do that. That is one of the reasons why the farmer is having so much difficulty.

Mr. **Webb**. Yes, sir.

Senator **Symms**. Thank you very much.

Mr. Davis.

STATEMENT OF THOMAS A. DAVIS, DAVIS & McLEOD, WASHINGTON, D.C., ON BEHALF OF THE NATIONAL CATTLEMEN'S ASSOCIATION, DENVER, COLO.

Mr. **Davis**. Mr. Chairman, my name is Tad Davis. I am here representing today the National Cattlemen's Association, and I have with me Burton Eller, who is the Washington vice president for government affairs. We would like to say, once again, thank you for your continuing interest in reducing the estate tax burden on farmers and ranchers and for your interest in improving the administration of the estate tax laws. S. 2479 is another step in that direction.

Today I would like to comment on only three areas of the bill. First, under the extended payment provisions, deferral is available only with respect to the tax attributable to qualifying closely held business interests. A qualifying business interest must either be a trade or business carried on by a decedent as a proprietor or as an interest in a partnership or corporation which is engaged in carrying on a trade or business at the time of the decedent's death. If a business has been carried on by a decedent as a sole proprietorship, the closely held business includes only the assets of the decedent which are actually utilized in that business.

In a series of rulings, the IRS has taken a rather restrictive definition of what is a trade or business. In general, these rulings do not treat the management of income-producing property as a trade or business. Consequently, splitting up an owner's business by transferring some assets to a corporation owned by the family but retaining individual ownership of other assets which are leased to the corporation can prevent his estate from using the installment payment provisions.

In one situation, a decedent incorporated a sole proprietorship but retained personal ownership of the land and buildings. The decedent leased the real property to the corporation, which used it in the corporation's business. However, the IRS ruled that the decedent's ownership of the real property did not qualify as a business, and therefore it could not be taken into account in determining whether the estate qualified for the deferral of estate taxes under the percentage requirement.

Recently the IRS did issue a more liberal interpretation of "trade or business" requirement where the decedent or the decedent's agent performed substantial services in connection with a lease; but that lease was from a crop share lease rather than a cash rental. It appears, therefore, that a cash lease of a farm property by a decedent to a family corporation or partnership will not meet the "trade or business" test but that a crop share lease may. Yet it is common occurrence for farmers and ranchers to cash lease farm and ranch land to a family-owned business. It is also common to use crop rentals; but the crop rental does qualify, a cash rental will not. It is inequitable to deny the benefits of deferred payment of estate tax to estates of these farmers who do rent on a cash rent basis. S. 2479 does solve these problems.

Turning to judicial review of the section 6166 qualifications, we would like to concur with the others who have spoken before to the question of allowing judicial review.

Finally, on the question of interest rate for deferred payments, I don't know that I can add too much more to what has already been said. Let me say only that most commercially viable cattle ranches and other similar types of large-scale farm operations are worth more than $1 million, and they obviously cannot afford to pay 20 percent interest rates in deferral of estate taxes and at the same time keep up their debt service on their operating loans. So we, too, support some provision which caps or reduces the interest rate.

There also should be some attention given to the administrative and compliance difficulties created under present law, when the interest on the deferred tax is claimed as an estate tax deduction. Under current law, the amended return has to be prepared and filed each year during the deferral period. This is a burdensome and costly process.

While perhaps not perfect, S. 2479 does contain provisions which would address these interest problems.

Now, Senator, on a last note which has nothing to do with S. 2479, I would like to bring to your attention a bill that was introduced on the House side by Congressman Downey. This bill would repeal the increase in the estate tax exemption, going to $600,000, and freeze it at the $175,000 level, and would increase the maximum estate tax rate back to 70 percent, up from the 50 percent which is now scheduled to go into effect. I would hope that you would keep your eye on that legislation on this side, and I would trust that you would oppose such measures if the issues do come up in the Senate.

Thank you.

Senator SYMMS. Thank you very much. I think that last note that you bring to my attention only makes the point that it is a constant struggle in this town to hold back the forces who would raise taxes on any area they can find to give them more revenue to go out and shop around to see how they can buy some votes from some other group of people with somebody else's money. That's been going on for a long time and isn't anything new. I'm not surprised that that's been introduced, and I would hope with the full support that we had last year that we would not have any difficulty of legislation like that passing. But I think it's worthy to remind us to be cautious, that it doesn't end up as a rider, or something like that, at some point in the future.

Thank you. Excellent statements on both your parts.

Now, Mr. Kelly.

STATEMENT OF DONALD KELLY, CHAIRMAN OF THE AMERICAN BAR ASSOCIATION REAL PROPERTY PROBATE & COST LOSS SECTION COMMITTEE ON THE DEFERRED PAYMENT OF ESTATE TAXES

Mr. Kelly. Thank you, Mr. Chairman. I am chairman of the American Bar Association Real Property Probate and Cost Loss Section Committee on the Deferred Payment of Estate Taxes, and in part the views I would express represent those of individuals who are members of that committee. I would add that in no sense do they represent views of the American Bar Association or its section on real property probate and trust law and have not been endorsed by either the association or the section.

Our committee consists generally of practicing lawyers who are concerned with estate problems and the problems of small business. I am speaking with reference, primarily, to small farms and small family business operations.

The primary purpose of the estate tax deferral provisions is to preserve the application of capital to productive business use in family businesses. The deferral provisions further promote the ability of a family business to withstand the loss of a key individual by death and proceed with the effective and economic application of those business assets to the creation of jobs and the constructive participation in the American economy.

The estate tax deferral provisions greatly assist this process.

The issues which have been already spoken to I will try not to duplicate, but there are some things which are matters of priority to us that I would like to stress.

The interest rate, as has been alluded to by several speakers, is of course far beyond both the cost of capital to businesses and the productive power of businesses. It seems to me that the best approach to the interest rate is not through what it costs in the capital markets but through what small business can produce. And I would just mention, in this regard, that the Treasury has many times testified before this committee that farms will produce less than 4 percent upon their fair market value. A 20-percent interest rate is of course absurd in this light on the deferred payment of estate taxes and contributes nothing to the alleviation of the problem that section 6166 was designed for.

The other problem I would like to pay particular attention to is that of eligibility of the typical small business retirement situation. The bill that we have been discussing addresses this through alleviation of the holding company problem and alleviation of the problem of the decedent cash-leasing property.

There are some other related problems that should be drawn, perhaps, to the committee's attention.

It is very common for the owners of small businesses to achieve arrangements with their children whereby they retire from business activity in exchange for a fixed cash payment. If this is done in an unsophisticated manner the result many times is a loss of eligibility for section 6166. The statute as it now is, is complex. The bill is complex. The problem is complex. But it is extremely nonproductive, it seems to me, for a situation to exist in which the ability of that business to withstand the estate tax depends entirely upon the sophistication of the advisers of the decedent.

In the course of our practice we are called upon many times to address these kinds of problems, and it is always distressing to see when the very technical hurdles of eligibility on section 6166 have not been cleared by the decedent merely for reasons of form.

For example, I am acquainted with a situation in which the decedent, being very preoccupied with his sons' succeeding to his business, made a deathbed gift of the business to those sons. That gift, which would have been formerly classed as a gift in contemplation of death but is now not so under the 1981 act, would leave the business not eligible for the 15-year 4-percent deferral, merely because of the lack of sophistication on the part of the decedent.

I am acquainted with another situation in which the decedent had incorporated his family farming land primarily for the purpose of being able to take advantage of the annual gift tax exclusions. That land was then cash-leased to himself for convenience. That would not be eligible under the current state of the law.

These lease and cash arrangement situations should be addressed in the law, and eligibility should be extended to them.

There is a continuing problem on transactions within the 3-year period. The present law brings those back in for determination of eligibility only, which prevents predeath gifts of nonbusiness assets to create eligibility but does not allow eligibility to extend to predeath gifts. And I would encourage the committee's further consideration of this problem.

We agree with the provisions of the task force bill relating to the coordination of section 6166 with section 303 redemptions, which I think are very important, for the same reason: to eliminate inadvertent problems in acceleration.

The holding company provisions are important, and we feel they should be continued in any bill which is passed.

The debt-equity structure provisions of the task force bill are also helpful.

Thank you very much.

[The prepared statements of the previous panel follow:]

TESTIMONY OF H. REITER WEBB, JR., WASHINGTON ATTORNEY OF THE NATIONAL COTTON COUNCIL OF AMERICA

Mr. Chairman, I am H. Reiter Webb, Jr., appearing before the Subcommittee today as Washington Attorney of the National Cotton Council of America. As you probably know, the Council represents all segments of the U.S. cotton industry, including producers, ginners, warehousemen, merchants, textile mills, cooperatives and the cottonseed crushing industry.

On behalf of the Council, I am here to voice our strong support for S. 2479, a bill to make certain technical corrections in Section 6166 of the International Revenue Code; specifically, those concerning the calculation of and reduction of interest incurred when the executor elects to extend the time of payment of the estate tax attributable to closely-held business interests, including farms.

One of the prime purposes of Section 6166 of the Internal Revenue Code is to allow the owners of closely-held businesses, including farms, to pay estate taxes in installments, rather than at once, so that these family businesses and farms would not have to be sold in order to pay taxes. We believe that policy made sense when Section 6166 was enacted. We believe it makes sense today. However, when the present Section 6166 was enacted in 1976, we lived in a different economic world. Interest rates were 7 percent and were reduced to 6 percent in 1978. Obviously, it was never envisioned that the rate of interest to be paid on deferred installments of estate tax would defeat the very purpose of the Section, namely allowing family businesses and farms to continue to exist. For example, as recently, as 1979, the interest rate payable under Section 6166, when estate taxes were to be paid in installments, was 4 percent on the first $307,800 of tax and 6 percent on anything in excess of that amount.

Legislation enacted in 1975 changed the interest rate payable on deferred estate taxes from a flat rate fixed by statute to a rate determined by a formula related to the prime rate. The first rate computed under this formula, effective in 1976, was 7 percent, and in 1978 the formula rate became 6 percent.

The application of the formula today results in an astounding 20 percent interest rate being paid on deferred estate taxes, a rate which was certainly not contemplated when Section 6166 was enacted. Together with two consecutive years when cotton farmers generally lost money, and very uncertain prospects for significant recovery in 1982/83, the 20 percent interest rate presents the heirs with an almost insurmountable cash flow problem. Indeed, any time interest rates are high, the heirs are usually faced with the extra interest on the deferred tax at the very time that they are suffering from high operating costs and depressed markets. High interest rates nearly always result in economic stagnation because of inventory reduction all through the marketing chain, as well as more modest consumer purchases.

In the absence of some change in the provisions of Section 6166, the solution might appear to be the sale of enough land to pay off the estate tax in full, since the sale of small blocks of land to pay annual interest is usually not feasible in agricultural areas. However, today's difficult financial conditions almost certainly rule this out as a solution. In the first place, it would be virtually impossible to find a buyer willing and able to pay cash for the land. It is much more likely that a buyer would want to make only a minimum down payment, and the seller would be forced to carry paper for the balance. While interest rates are still far above levels previously considered normal, they are well below the 20 percent being charged on deferred estate taxes. Furthermore, sellers of land and other real estate are finding it increasingly necessary to engage in "creative financing" at interest rates lower than current levels in order to make a sale. The interest earned on that part of the sale being financed by the seller would be substantially lower than the 20 percent interest being paid on the deferred estate tax. Consequently, it would probably be necessary to sell a substantial portion of the total farm in order to realize enough cash to pay the estate tax, plus any capital gains tax that might be due; a sale which could change the basic nature and efficiency of the farm unit to the point where the best alternative might well be to sell the entire farm—the very result Section 6166 is intended to prevent.

Another major problem in trying to sell enough land to pay off the estate tax in full is that of the underlying mortgages. In many cases, these would be at interest rates substantially lower than those of today, and may be "due on sale." Obviously, the lenders under those mortgages are not going to allow them to be assumed at the old rates. The heirs would again be faced with painful alternatives. If they are forced to pay off the old mortgages and refinance the property at today's interest rates, the higher mortgage payments could easily make the entire farming operation unprofitable. If the sale proceeds are used pay off the old mortgages, as well as the estate tax due, it is highly likely that there would not be enough land or money remaining to continue in operation as a viable farming unit.

Last year, a highly qualified Task Force on Technical Revision of Section 6166 was formed to lend their expert knowledge so that the full intent of Congress could be realized. The Task Force has made four (4) recommendations concerning the interest rate on deferred taxes arising from closely-held businesses, and the Council supports all four. These are: (1) the interest arising from the deferral of estate tax should continue to be deductible as an administrative expense; (2) the rate should be fixed for the entire deferral period, geared to the then prevailing yield on Treasury obligations of comparable maturity; (3) all of the interest payable during the deferral period, including interest imposed by a State, would be deductible when the estate tax return was filed; and (4) while the changes proposed above would generally apply to decedents dying after December 31, 1981, a transition rule covering decedents dying before January 1, 1982, would permit such estates to elect to utilize the new interest deduction provisions for the post-1981 payout period.

We believe that the recommendations of the Task Force are workable, consistent with the intent of Section 6166, and will correct what will otherwise become a very unfair situation in the future between the estates of decedents with closely-held businesses who died before January 1, 1982, and those dying thereafter. Since executors can elect to defer estate taxes for as long as fourteen (14) years, it is important to compare the tax situations that will be faced by the estates of decedents who come under the provisions of the Economic Recovery Tax Act of 1981 (ERTA) and those of decedents who died earlier since many of the latter will still be paying estate taxes and interest long after the more liberal provisions of ERTA are fully phased in during 1985. Obviously, the estates of those dying before January 1, 1982, will face a serious cost disadvantage long into the future compared with those covered by ERTA. The Council believes that the recommendations of the Task Force are fair and will tend to equalize the situations faced by the estates of decedents who died before ERTA was applicable.

Statement of the National Cattlemen's Association, Presented by Thomas A. Davis

SUMMARY

Section 6166 Technical Revision Act of 1982

The National Cattlemen's Association (NCA) applauds Senator Symms for his continuing interest in reducing the estate tax burden on farmers, ranchers, and other small businesses and his interest in solving administrative problems created by the estate tax laws. S. 2479, which he introduced, addresses a number of technical improvements needed in the deferred payment of estate tax provisions of Section 6166 of the Internal Revenue Code. NCA also commends Senators Bentsen, Boren, Grassley, Helms, Jepsen, Johnston, Mathias, Mattingly, McClure, Nunn and Zorinsky for cosponsoring this important and needed bill.

NCA is concerned that farmers, ranchers and other small businessmen should be able to obtain the full benefits of deferred payment of estate taxes. Some provisions of and interpretations given to Section 6166 have resulted in making it unavailable and unduly complex. Technical amendments in S. 2479 would deal with a number of problems which have occurred under Section 6166.

NCA supports and urges enactment of the provisions of S. 2479 which would: (1) permit assets owned directly or indirectly by a decedent to qualify for deferred payment of estate tax where such assets are leased to or used by a family owned business; (2) provide a judicial forum for settling disputes with the IRS over eligibility under Section 6166; and (3) modify the rules concerning the amount of interest imposed on deferred estate tax payments and the manner in which such interest can be claimed as an estate tax deduction. While the rules relating to interest should be changed, it is important to retain the four percent interest rate on the tax on the first $1 million in value of a closely held business interest, as this bill does.

STATEMENT

Introduction

For a number of years, the National Cattlemen's Association (NCA) and other agricultural organizations have been concerned about the impact of estate tax laws upon the owners of family farms, ranches, and other closely held businesses. Over the years, Congress has addressed these concerns through Section 6166 of the Code. This section permits an estate to defer a portion of the estate taxes attributable to certain closely held businesses and to pay off these taxes over a period of up to 15 years.

From time to time, technical problems resulting from unanticipated factual situations or overly restrictive IRS interpretations have resulted in the benefits of this 15 year deferral provision not being available to family farms and ranches. As a result, Congress has reexamined this provision and made changes to insure that estate tax deferral is available for the types of taxpayers whom they intended to benefit. Thus, improvements in this provision were made in the Tax Reform Act of 1976 and again in the 1981 Tax Act.

Notwithstanding the significant improvements which have been made to this extended payment provision, there are still a number of additional changes which would substantially improve it.

NCA commends Senator Symms for his continuing interest in improving the administration of the estate tax laws. S. 2479 is another step in that direction. NCA also compliments Senators Bentsen, Boren, Grassley, Helms, Jepsen, Johnston, Mathias, Mattingly, McClure, Nunn and Zorinsky for sponsoring this important bill. NCA supports the basic goal of making the extended payment provision more workable and administrable.

NCA supports technical improvements to section 6166

Under the extended payment provisions, deferral is available only with respect to the tax attributable to qualifying closely held business interests. A qualifying business interest must be either a trade or business carried on by the decedent as a proprietor or an interest in a partnership or corporation which is engaged in carrying on a trade or business at the time of the decedent's death. If a business has been carried on by a decedent as a sole proprietor, the closely held business includes only the assets of the decedent which are actually utilized by him in the trade or business.

In a series of rulings, the IRS has set forth guidelines for determining what constitutes a trade or business for purposes of Section 6166. These guidelines set up a somewhat narrower definition of a trade or business than applies in other areas of the tax law. In general, these rulings do not treat the management of income-producing property as a trade or business. Consequently, the splitting of an owner's business by transferring some assets to a family corporation but retaining individual ownership of the farm real property which is leased to the corporation may prevent his estate from using installment payments for estate tax purposes. In one situation, a decedent incorporated a sole proprietorship but retained personal ownership of the land and buildings used in the business. The decedent leased the real property to the corporation which used it in the corporation's business. The IRS ruled that the decedent's ownership of the real property did not qualify as a business and, therefore, could not be taken into account in determining whether the estate met the percentage requirements for deferral of estate tax.

Recently, the IRS has made a more liberal interpretation of the "trade or business" requirement where the decedent or the decedent's agent performed substantial personal services in managing, maintaining and leasing the property. In a farm or ranch context, this generally means that a decedent's estate may satisfy the "trade or business" test if there is material participation under a crop-share lease of the property. However, the IRS position appears to be that a cash lease of farm or ranch property by a decedent to a family corporation or partnership will not meet the "trade or business" requirement. Yet, it is a common occurrence for farmers and ranchers to cash lease agricultural property to a family owned business. To deny the benefits of deferred payment of estate tax to the estates of these farmers and ranchers seems inequitable.

Similarly, giving up active participation in farming or ranching because of age and health may result in the loss of the use of the extended payment provisions. In one situation, a 96-year old farmer gave his children the livestock used on his farm and leased the farm property to them on a rent-free basis. The farmer, who took no further interest in the management of the farm, died a year later. The IRS ruled that neither the livestock, which was included in his estate because the gift was made within three years of his death, nor his real property qualified as an interest in a closely held business because he had not actively participated in carrying on the farm business. Thus, as interpreted by the IRS, the present provisions are not adequate to allow estate tax deferral in many situations where the family is carrying on a trade or business on property even though the decedent is not personally doing so.

S. 2479 solves these problems caused by IRS interpretation of what is a "trade or business." The bill provides that extended payment of estate taxes would apply to assets used by a closely held business whether such assets are directly owned by the business or leased to the business by a partner or shareholder. Thus, assets that were directly or indirectly owned by the decedent and leased to a family owned business would qualify for deferred payment of estate tax if such assets were used in the business for a period of one year prior to the decedent's death and if the decedent's interest in the business met the requirements of Section 6166. As it has in the past, NCA strongly urges passage of this important and needed provision.

Judicial review of section 6166 qualification

There are many circumstances under which it may not be clear as to whether an estate is eligible to elect to defer estate taxes under Section 6166. Because of the language of the jurisdictional provisions of the Code, it appears that there is no practical way to contest in court a decision by the IRS to deny the executor's election to defer estate taxes under Section 6166.

NCA believes that estates should be able to obtain judicial review of disputes with the IRS arising under Section 6166. This problem would be remedied by S. 2479 which would provide a judicial forum for reviewing questions raised by IRS regarding whether estates qualify for the right to defer payment of estate taxes. For the same reasons, NCA believes that disputes arising under Section 2032A, which allows the special use valuation of farm and ranch property, should be subject to judicial review even if the disputes do not result in a current tax deficiency.

Modification of interest rate for deferred payments

Under present law, a 4 percent interest rate is available with respect to the estate tax liability on the first $1 million of the taxpayer's gross estate which is deferred under the extended payment provision of Section 6166. All other interest on amounts of estate tax deferred under Section 6166 bears interest at the same rate that underpayments of taxes generally bear. By reasons of changes made in the 1981 Tax Act, the rate of interest on underpayments of tax is to be 100 percent of the prime rate and is to be adjusted annually. Under the new rules, the rate of interest was raised to 20 percent as of February 1, 1982. As a consequence, the availability of Section 6166 to estates of farmers, ranchers and other closely held businesses has been seriously impeded since many of these estates cannot afford to pay this high rate of interest.

Most commercially viable family cattle operations are extremely capital intensive—requiring substantial capital investment in land, livestock, buildings and equipment. In many areas of the country, a commercially viable ranch necessarily will exceed $1 million. Consequently, many farm and ranch estates will exceed $1 million even though the owners are not thought of as wealthy, and these estates will be able to defer payment of estate taxes only by paying 20 percent interest on a portion of the tax deferred. The assets used in cattle and other agricultural operations normally cannot generate the type of cash return necessary to service an estate tax debt bearing a 20 percent interest rate, particularly when most ranches are also servicing high-interest operating loans. As a result, the allowance of a deferred payment provision with high interest rates will not provide any meaningful benefit to many estates containing cattle or other farm operations. In order to provide for a deferred payment provision with utility to cattle and other agricultural operations, the interst rates should have a cap or some other limitation which would be significantly below the prime rate.

Besides retaining the current four percent rate and placing a reasonable rate on the excess amount exceeding that qualifying for four percent, attention needs to be given to the administrative and compliance difficulties created under present law when the interest on the deferred tax is claimed as an estate tax deduction with the result that an amended estate tax return has to be prepared and filed each year during the deferral period. This is burdensome and costly both to estates and to the IRS.

While perhaps not perfect, S. 2479 contains provisions which would address these problems. Under S. 2479, the four percent interest rate would be retained and the interest rate on the excess estate tax would be geared to the then prevailing yield on Treasury obligations of comparable maturity. All interest attributable to the deferred payment of estate tax would be deducted when the estate tax return was filed. This would eliminate the need to recompute the estate tax and file an amended estate tax return for each year of the payout period. Thus, S. 2479 would preserve the current rules on deductibility of interest on the deferred tax and would greatly simplify current procedures. NCA endorses this provision of S. 2479 and would urge its passage.

CONCLUSION

Again, we compliment Senator Symms and the other cosponsors for introducing S. 2479. This bill addresses a number of technical problems in Section 6166 which should be corrected. Specifically, NCA wold urge enactment of the provisions of S. 2479 which would: (1) permit assets owned directly or indirectly by a decedent to qualify for deferred payment of estate tax where such assets are leased to or used by a family owned business; (2) provide a judicial forum for determining eligibility under Section 6166; and (3) modify the rules concerning the amount of interest which can be imposed on deferred estate tax payments and the manner in which such interest can be claimed as an estate tax deduction.

NCA and its technical advisors would be pleased to work with the members of this Subcommittee and with staff in analyzing the impact the provisions of this bill would have and making any amendments to the bill would carry out its intended purposes.

Senator SYMMS. I wish to thank all three of you for very excellent testimonies. If we have any questions—and this would go for any of the witnesses here—we will submit them to you in writing, in order to move along with the hearing.

Now I would like to hear from Martin Worthy and James Heinhold.

Mr. Worthy.

STATEMENT OF K. MARTIN WORTHY, HAMEL, PARK, McCABE & SAUNDERS, WASHINGTON, D.C.

Mr. WORTHY. Thank you, Mr. Chairman.

My name is K. Martin Worthy. I am a lawyer in the firm of Hamel, Park, McCabe & Saunders in Washington, D.C., and have practiced tax law for more than 30 years.

I am here today to testify in support of S. 1983, which would amend section 2518 of the code relating to disclaimers. The amendment is intended, as you, Mr. Chairman, stated in your opening remarks, to rectify an inequity with respect to disclaimers of interests created before 1958 which are now governed only by case law and regulation.

I represent the estate of Mrs. Helen Wodell Halbach, who died while a resident of New Jersey in 1972. Mrs. Halbach's father died in 1937, and by his will established a trust with the income to be paid to Mrs. Halbach's mother for life, with the remainder to be divided equally between Mrs. Halbach and her sister in the event of their survival of their mother. Thus, Mrs. Halbach's interest was wholly contingent and would not vest or become possessory in any sense until after her mother's death.

Mrs. Halbach's mother died on April 14, 1970, and Mrs. Halbach, 4 days later, executed a document in which she irrevocably renounced and disclaimed all her right, title, and interest in the one-half share of the trust to which she would otherwise have been entitled.

The bank administering the trust thereupon brought an action in the New Jersey courts to determine the effect of the disclaimer; and the Chancery court in New Jersey, in a carefully developed opinion published at 274 Atlantic 2d 614, held in late 1970 that the disclaimer, having been executed promptly after the death of the life tenant, was effective to prevent any passage of title to Mrs. Halbach. The court required distribution of the half interest in the trust to which Mrs. Halbach would otherwise have been entitled just as if Mrs. Halbach had not survived.

The court significantly noted not only that this was the accepted law of New Jersey but also that the Court had been unable to find any rulings in any State that to be effective a remainderman's renunciation must occur within a reasonable time after learning that a remainder interest has been created rather than, as the Court determined, a reasonable time after termination of the life interest.

As we will demonstrate in a moment, Mrs. Halbach had no reason to believe, when she executed her disclaimer in 1970, that she had in any way made a transfer of property subject to gift tax. However, by reason of the Supreme Court's decision earlier this year in *Jewett* v. *Commissioner* and the failure of Congress in enacting section 2518 to deal specifically with disclaimers of interests created before 1976, Mrs. Halbach's estate is being threatened with a gift tax on the value of the interest in the trust which she disclaimed in 1970 just as if she had accepted it and then later voluntarily transferred it to persons of her own choosing.

It has been accepted for nearly 50 years that a disclaimer or a renunciation refusing to accept a gift or transfer by will, is not itself a transfer subject to gift or estate tax if the disclaimer is timely and properly made. Although until 1976 the code contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a regulation recognizing this court-established principle.

Before the 1958 regulation the court of appeals had made it clear that a disclaimer which was valid and effective under State law did not result in a taxable gift. Although there was some variance in State disclaimer statutes and some States had no disclaimer statutes at all, it was clear from the authorities, such as Page on Wills, that as a general rule a disclaimer of an interest was valid under State law if it was unequivocal, made without prior acceptance, and made within a reasonable time. Furthermore, just as later held by the New Jersey court in connection with Mrs. Halbach's disclaimer, in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

In the *Jewett* case, however, the Supreme Court last February held that under the 1958 regulation a disclaimer after 1958 of an interest created before section 2518 was enacted in 1976 will be recognized as free from gift tax only if the disclaimer is made shortly after the initial transfer from which the interest sought to be disclaimed eventually emerged.

Under this interpretation future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. Since this is clearly contrary to the accepted law before 1958 and contrary to what many justifiably understood the law still to be in the period even after the regulation was promulgated in 1958 until at least 1972, well after Mrs. Halbach and others executed disclaimers the Supreme Court's decision is, as you pointed out earlier, Mr. Chairman, very unfair to holders of interests created before 1958 who had no reason to disclaim before that time and never had an opportunity to disclaim without gift tax, even within a reasonable time, after the regulation was promulgated.

The 1958 regulation, which is still in effect today as to pre-1976 disclaimers, provides that where local law "gives a beneficiary * * * a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent * * *, a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer."

Now, this language differs significantly from an earlier published proposed regulation which would have required that a disclaimer be made within a reasonable time after knowledge of the existence of the interest rather than within a reasonable time after knowledge of the existence of the transfer. Certainly it was reasonable to assume that the Treasury intended that to make an effective disclaimer without gift tax, the holder of a contingent remainder would have a reasonable time after his interest became present and possessory by transfer of the property to him, instead of merely a reasonable time after the creation of the interest as would have been required by the earlier draft.

The Supreme Court in *Jewett,* however, did not accept this interpretation of the final 1958 regulation. It referred instead to a memorandum circulated internally within the Treasury and not published until 1981, which indicated without any mention of contingent remainders that changes in language which were made in the final regulation were intended simply to make clear that the effectiveness of a disclaimer for gift tax purposes would turn on State law in all circumstances and not upon certain inflexible rules in the original draft.

In any event, even if the purpose of the change in language was not the purpose suggested by comparison of the draft with the final regulation, this purpose would not have been apparent to holders of contingent interests at the time, since the Treasury memorandum relied on by the Supreme Court was not made public until 1981. And if the change in language was intended to make clear the overriding importance of State law, this would necessarily mean that the law applicable in New Jersey and most if not all States, that in the case of an interest which did not take effect in immediate possession a disclaimer did not have to be made until a "reasonable time" after the termination of the preceding interest, would apply to disclaimers such as that by Mrs. Halbach.

It has now been admitted by counsel for the Government in the *Jewett* case that there is no evidence, before litigation in the *Keinath* case in the Tax Court in 1972, that the Internal Revenue Service publicly took the position that the 1958 regulation required the holder of a future interest to disclaim shortly after the interest was created rather than after the termination of the preceding interest.

Senator SYMMS. Mr. Worthy, with my apologies, we have reached the second bell. It is on a vote on cloture on the floor. If you will just suspend for a few moments, the committee will stand in recess until 20 minutes until 4.

Mr. WORTHY. Thank you, sir.

[Whereupon, at 3:25 p.m., the hearing was recessed.]

AFTER RECESS

Senator SYMMS. I apologize that the recess extended past the 20 minutes to the hour, but just as I got to the top of the elevator the bells rang again, and I had to return to the floor.

Mr. Worthy, I believe we were just about wrapping up your statement. You were on page 6, I believe. So, why don't you go ahead.

Mr. WORTHY. Yes, sir. If I could have just about a minute or a minute and a half more.

Senator SYMMS. All right.

Mr. WORTHY. Mr. Chairman, I would now like to refer to what I consider to be a rather important new discovery. Despite an assertion by the Supreme Court in the *Jewett* case that the position that the 1958 regulation required the holder of a future interest to disclaim shortly after the interest was created rather than after the termination of the preceding interest had been the consistent interpretation of the 1958 regulation by the Internal Revenue Service over the years, it now appears that it is in fact inconsistent with the Service's own position in a private-letter ruling, 6612201590A, dated December 20, 1966, and only recently released to the public.

In that ruling the Service specifically held that a taxpayer's proposed disclaimer of a contingent interest in one-fourth of the income of a trust created 33 years earlier would not be a taxable gift.

The Service ruled, specifically, that if the renunciation was executed, and I quote, "within a reasonable time from the time that she first received notice of her right to the additional income interest," by reason of a court decision that the income interest had vested in her because of her survivorship of two of her siblings, the requirements of the 1958 regulation would be satisfied.

Because the taxpayer already held another income interest in the same trust, she had obviously long been aware of the creation of the trust 33 years earlier and of her contingent survivorship rights. In fact, after going back as far as 1954, the first ruling, public or private, that I was able to find which requires disclaimer of a future interest before the preceding life tenant's death was not until 1978—5 years after such position had been rejected by the Eighth Circuit Court of Appeals in the *Keinath* case, and I might add, 8 years after Mrs. Halbach disclaimed her interest.

Under the Supreme Court's interpretation the IRS, by promulgating the 1958 regulation, suddenly changed the rules in the middle of the game for a taxpayer owning a contingent interest created before 1958 without any opportunity ever to make a tax-free disclaimer thereafter.

S. 1983 would correct the unfair effect of *Jewett* on holders of pre-1958 future interests by providing a grace period for disclaimers of such interests, and I strongly urge its enactment.

I would like the privilege of filing for the record a more complete technical analysis, which I have here and have submitted to the staff, discussing in detail all of the authorities to which I have referred.

Senator SYMMS. Without objection, it will be made a part of the record.

Mr. WORTHY. Thank you very much for this chance to present my views, and I will be glad to answer any questions, Mr. Chairman.

Senator SYMMS. Thank you very much, Mr. Worthy, for a very excellent statement and a very interesting case study, which certainly points to the reason why we need this legislation. I thank you again.

Mr. Heinhold.

STATEMENT OF JAMES C. HEINHOLD, SHEA & GOULD, WASHINGTON, D.C.

Mr. HEINHOLD. Good afternoon, Senator.

My name is Jim Heinhold, and I am an attorney with the firm of Shea & Gould here in Washington. I am accompanied by the Honorable Wilbur Mills, also of our firm.

I am indeed in distinguished company with K. Martin Worthy, the former chief counsel when I was at the IRS, and my former boss and now friend, Senator Carl Curtis. But another former boss of mine, Senator Russell Long, would say that testifying before you is like "preachin' to the choir," because it is through your good offices and the work of your staff that we are getting an opportunity to redress a wrong.

It is very difficult to get the attention of the Congress on issues that do not make headlines. The problems with section 6166 are such issues. You may never get a headline for your work in this area, Senator Symms, but the working estate bar acknowledges and appreciates it.

The problem with a disclaimer is a similar-type issue that will not grab headlines. It will not have mass appeal; but, nevertheless, it is an area where there has been an injustice and where the Congress has a chance to correct it.

Mr. Worthy has eloquently testified as to the technical basis for the relief that we seek. It is late in the day, and there is no need to repeat the technical details. I don't want to risk having the choir fall asleep—so, if the chairman would permit my prepared statement to be included in the record I would like to tell you about the facts rather than the law.

The trust I am concerned with was created in 1934 for the benefit of the testator's child during her life. The remainder would pass to the child's children, if any, and if there weren't any it would pass to various aunts and uncles, if they were still alive, or else it would go to their children.

Our client, Eleanor, was the niece of the child for whom the trust was created. Eleanor would be entitled to take something under the trust, if, and only if, (1) she survived her mother; and (2) that her aunt died without children.

Eleanor was only 6 years old when the trust was created, and she was told nothing about it. The possibility of her receiving anything under the trust was simply too remote. When Eleanor was 18 years old the surrogate court did send a notice of the trust; but it was sent to Eleanor's mother, not to Eleanor. Nevertheless, the IRS now says that Eleanor learned of the trust by that notice.

Naturally, at that time Eleanor did not ask an attorney what to do; but if she had, she would have been told to do nothing, because the accepted principle of State law at that time was that you did not have to disclaim until you actually were entitled to receive something. And the IRS followed that principle.

What Eleanor did not know was that years later the IRS would write a regulation and expect Eleanor to have followed it 12 years before it was written.

Senator SYMMS. Let me ask a question. Was the trust formed in 1934? And was it 1958 when she got the notice?

Mr. HEINHOLD. Actually, in 1946 the notice was sent to her mother—1946.

In November 1958, 12 years after Eleanor turned 18 and supposedly learned of the trust, the IRS made up some rules on disclaimers. But if Eleanor disclaimed 5 minutes after the rules were written, and even though she was still not entitled to receive anything under the trust, she would have been too late because the IRS would not let her conform to the new rule in 1958.

In 1958 the IRS declared that Eleanor should have disclaimed in 1946 when she was 18, even though the IRS rule had not even been contemplated at that time. But none of this was known in 1946. Eleanor's mother died in 1957, and her aunt died, childless, in 1974. Eleanor was then told about the trust. Immediately she disclaimed. She never accepted any benefit from the trust nor used it in any way.

The truly ironical part is that the IRS rule did not get into the Internal Revenue Code until 1976. And, when it did, Congress said two things: First, that the new stricter standards would not apply to trusts that were created before 1976; and, two, that trusts written after 1976 would have 9 months to disclaim.

And yet, here we sit. Trusts written 20 years before 1958 have never been given a chance to conform to the new rules, nor can they do so now. But trusts written 20 years after 1958, 20 years after the rules have been written, are given 9 months to disclaim.

We are not asking that the tougher standards passed in 1976 be repealed. We are not even asking that pre-1958 trusts escape the new standards. All we are asking is that pre-1958 trusts be given the same chance as post-1976 trusts; that is, 9 months to decide whether to take the property or leave it.

Senator, that is our case, and I appreciate the hearing.

Senator SYMMS. In other words, in the case of this Eleanor, she is given a tax—she had a tax liability, but she received nothing?

Mr. HEINHOLD. That is essentially correct. She said she didn't want the property, "don't want it coming to me," as soon as she heard of the trust. The IRS says that, in effect, she gave a gift. Our question is, how can you give something that you never had?

Senator SYMMS. She never received any benefit from it at all?

Mr. HEINHOLD. She never received any benefit, Senator; none at all.

Senator SYMMS. Well, that certainly makes our case. I appreciate it very much. Thank you both.

Did you have anything else you wanted to add, Mr. Worthy?

Mr. WORTHY. No, sir; I don't believe so.

Senator SYMMS. Thank you. I appreciate your testimony.

[The prepared statements of the previous panel follow:]

Statement of
K. MARTIN WORTHY
on S. 1983
before the
Subcommittee on Estate & Gift Taxation
of the Committee on Finance
United States Senate
May 27, 1982

My name is K. Martin Worthy. I am a lawyer in the firm of Hamel, Park, McCabe & Saunders in Washington, D.C. and have practiced tax law for more than 30 years.

I am here today to testify in support of S. 1983, which would amend section 2518 of the Internal Revenue Code of 1954 relating to disclaimers. The amendment relates to disclaimers of interests created before 1958, which are now governed only by case law and regulation.

I represent the Estate of Mrs. Helen Wodell Halbach, who died while a resident of New Jersey in 1972. Mrs. Halbach's father died in 1937, and by his will established a trust with the income to be paid to Mrs. Halbach's mother for life, with the remainder to be divided equally between Mrs. Halbach and her sister in the event of their survival of their mother. Thus, Mrs. Halbach's interest was wholly contingent and would not vest or become possessory in any sense until after her mother's death.

Mrs. Halbach's mother died on April 14, 1970, and Mrs. Halbach, four days later, executed a document in which she irrevocably renounced and disclaimed all her right, title and interest in the one-half share of the trust to which she would otherwise have been entitled. The bank administering the trust thereupon brought an action in the New Jersey courts to determine the effect of the disclaimer, and the Chancery court of New Jersey, in a carefully developed opinion published at 274 Atlantic 2d 614, held in late 1970 that the disclaimer, having been executed promptly after the death of the life tenant, was effective to prevent any passage of title to Mrs. Halbach. The Court thus required distribution of the half interest in the trust to which Mrs. Halbach would otherwise would have been entitled just as if Mrs. Halbach had not survived. The Court significantly noted not only that this was the accepted law of New Jersey, but also that the Court had been unable to turn up any rulings in any state that to be effective a remainderman's renunciation must occur within a reasonable time after learning that a remainder interest has been created--rather than a reasonable time after termination of the life interest.

As we will demonstrate in a moment, Mrs. Halbach had no reason to believe, when she executed her disclaimer in 1970, that she had in any way made a transfer of property subject to gift tax. However, by reason of the Supreme Court's decision earlier this year in Jewett v. Commissioner and the failure of Congress in enacting section 2518 to deal specifically with disclaimers of interests created before 1976, Mrs. Halbach's estate is being threatened with a gift tax on the value of the interest in the trust which she disclaimed in 1970 just as if she had accepted it and then later voluntarily transferred it to persons of her own choosing.

It has been accepted for nearly fifty years that a disclaimer or renunciation refusing to accept a gift or transfer by will, is not itself a transfer subject to gift or estate tax if the disclaimer is valid and properly made. Although until 1976 the Code contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a regulation recognizing this court-established principle.

Before the 1958 regulation the courts of appeals had made it clear that a disclaimer which was valid and effective under state law did not result in a taxable gift. Although there was some variance in state disclaimer statutes and some states had no disclaimer statutes at all, it was clear from the authorities (such as Page on Wills) that as a general rule a disclaimer of an interest was valid under state law if it was unequivocal, made without prior acceptance, and made within a reasonable time. Furthermore--just as later held by the New

Jersey court in connection with Mrs. Halbach's disclaimer--in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

In the Jewett case, however, the Supreme Court last February held that under the 1958 regulation a disclaimer after 1958 of an interest created before section 2518 of the Code was enacted in 1976, will be recognized as free from gift tax only if the disclaimer is made shortly after the initial transfer from which the interest sought to be disclaimed eventually emerged. Under this interpretation future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. Since this is clearly contrary to the accepted law before 1958 and contrary to what many justifiably understood the law still to be in the period even after the regulation was promulgated in 1958 until well after Mrs. Halbach executed her disclaimer in 1970, the Supreme Court's decision is very unfair to holders of interests created before 1958, who had no reason to disclaim before that time and never had an opportunity to disclaim without gift tax--even "within a reasonable time"--after the regulation was promulgated.

The 1958 regulation--which is still in effect today as to pre-1976 disclaimers--provides that where local law

> "gives a beneficiary ... a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent ..., a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer."

The regulation goes on that

> "the refusal must be unequivocable and effective under the local law."

This language differs significantly from an earlier published proposed regulation which would have required that a disclaimer be made "within a reasonable time after knowledge of the existence of the interest," rather than after knowledge of the existence of the "transfer." Certainly, it was reasonable to assume that the Treasury intended that to make an effective disclaimer without gift tax, the holder of a contingent remainder would have a reasonable time after his interest became present and possessory by transfer of the property to him, instead of merely a reasonable time after the creation of the interest as would have been required by the earlier draft.

The Supreme Court in Jewett did not accept this interpretation of the final 1958 regulation. It referred instead to a memorandum circulated internally within the Treasury and not published until 1981, which indicated, without any mention of contingent remainders, that changes in language which were made in the final regulation were intended simply to make clear that the effectiveness of a disclaimer turned on state law in all circumstances and not upon certain inflexible rules in the original draft. In any event, even if the purpose of the change in language was not the purpose suggested by comparison of the draft with the final regulation, this purposewould not have been apparent to holders of contingent interests at the time, since the Treasury memorandum was not made public until 1981. And if the change in language was intended to make clear the overriding importance of state law, this would necessarily mean that the law applicable in New Jersey (and most if not all states), that in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made until a "reasonable time" after the termination of the preceding interest, would apply to disclaimants such as that by Mrs. Halbach.

It has now been admitted by counsel for the government that there is no evidence before litigation in the Keinath case in the Tax Court in 1972, that the Internal Revenue Service publicly took the position that the 1958 regulation required the holder of a future interest to disclaim shortly after the interest was created rather than after the termination of the preceding interest. That is two years after the renunciation by Mrs. Halbach.

It now further appears that despite an assertion by the Supreme Court that this had been the consistent interpretation of the 1958 regulation by the Commissioner over the subsequent years, it is in fact inconsistent with the Service's own position in a private letter ruling (6612201590A) dated December 20, 1966, and only recently released to the public. In that ruling the Service specifically held that a taxpayer's proposed disclaimer of a contingent interest in one-fourth of the income of a trust created 33 years earlier would not be a taxable gift. The Service ruled that if the renunciation was executed "within a 'reasonable time' from the time that she first received notice of her right to the additional income interest," by reason of a court decision that the income interest had vested in her because of her survivorship of two of her siblings, the requirements of the 1958 regulation would be satisfied. Because the taxpayer already held another income interest in the same trust, she had obviously long been aware of the creation of the trust 33 years earlier and of her contingent survivorship rights. In fact, after going back as far as 1954, the first ruling, public or private, I was able to find which requires disclaimer of a future interest before the preceding life tenant's death was not until 1978 -- five years after such position had been specifically rejected by the Eighth Circuit Court of Appeals in the Keinath case.

Under the Supreme Court's interpretation, the IRS, by promulgating the 1958 regulation, suddenly changed the rules in the middle of the game for a taxpayer owning a contingent interest created before 1958 without any opportunity ever to make a tax-free disclaimer thereafter. S. 1983 would correct the unfair effect of Jewett on holders of pre-1958 future interests by providing a grace period for disclaimer of such interests, and I strongly urge its enactment.

I would like the privilege of filing for the record a more complete technical analysis which I have here discussing in detail all of the authorities to which I have referred.

Thank you very much for this chance to present my views, and I will be glad to answer your questions.

TECHNICAL ANALYSIS AND BACKGROUND OF S. 1983:
PROPOSED AMENDMENT TO SECTION 2518

Background of Proposed Amendment

It has long been established that a disclaimer or renunciation -- i.e. a refusal to accept a gift or transfer by will -- is not itself a transfer subject to gift tax if the disclaimer is timely and properly made. Although until 1976 the Internal Revenue Code of 1954 ("the Code") contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a regulation recognizing this court-established principle.

However, even under the regulation, the effectiveness of a disclaimer for federal tax purposes varied according to applicable state law. By the 1970's it had become apparent to members of the tax bar and others that a uniform definition of disclaimers would be desirable for federal tax purposes. See H. Rept. No. 94-1380, 66, 1976-3 C.B. (Vol. 3) 735, 800. The Section of Taxation of the American Bar Association accordingly recommended that the Internal Revenue Code be amended "to provide comprehensive uniform rules for the exemption from estate and gift taxes of property that is disclaimed in a specific manner within a specified time." Tax Section Recommendation No. 1974-2, 27 Tax Law. 818 (1974).

In response to the movement for a uniform disclaimer rule, Congress enacted new section 2518 of the Code in the Tax Reform Act of 1976. That section generally requires that a "qualified disclaimer" for Federal estate and gift tax purposes, i.e., a disclaimer that does not constitute a taxable gift, be made (a) in writing, (b) before acceptance of the interest being disclaimed or any of its benefits, and (c) within 9 months after the later of the date on which the transfer creating the interest is made or the day on which the disclaimant attains age 21. Section 2518 was subsequently amended in 1978 and 1981 to perfect and clarify the uniform rule.

Under present law section 2518 applies only to disclaimers of interests created after December 31, 1976. Thus, in the absence of amendment of section 2518, the broad class of disclaimants of interests in trusts created before 1958 remain subject to the law in effect before section 2518 was enacted, irrespective of when the interests become possessory and when the disclaimers are made -- even 40 or 50 or more years from now.

Text

H.R. 2583 and S. 1983 would add a new paragraph (3) to subsection 2518(c) of the Code.[1] The following language for such bills has evolved through a long series of conferences with members of the staffs of the Joint Committee on Taxation and the Ways and Means Committee:

> (3) PRIOR TRANSFERS. - A disclaimer of an interest created by a transfer of property made before November 15, 1958, shall constitute a 'qualified disclaimer' for purposes of this subtitle if -
>
> (A) such disclaimer satisfies the requirements of subsection (b) without regard to paragraph (2) thereof, and
>
> (B) such disclaimer is made -
>
> (i) at any time prior to 9 months following enactment of this paragraph, or
>
> (ii) within 9 months of the first day the disclaimant had knowledge of such interest, provided the first day the disclaimant had knowledge of the interest is established by clear and convincing evidence (but in no event shall this clause apply to a disclaimer made after December 31, 1991).

The proposed amendment would make disclaimers of interests created before November 15, 1958, (when the disclaimer regulation was first promulgated) subject to the requirements of section 2518 described above, but would provide a special transitional rule governing the period in which a qualified disclaimer of such an interest could be made. That period would generally end nine months following the enactment of the bill, or nine months after the first day the disclaimant had knowledge of the interest, if later.

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[1] Since H.R. 2583 was introduced on March 18, 1981, section 2518 of the Code has been amended by the Economic Recovery Tax Act of 1981, P.L. 97-34, which added a new paragraph (3) to subsection 2518(c). Thus, the bills should be amended to add a new paragraph (4) rather than (3) to that subsection.

Reasons for Proposed Amendment

In Jewett v. Commissioner, 102 S. Ct. 1082 (1982), the Supreme Court of the United States, interpreting section 25.2511-1(c), Gift Tax Regs., held that a disclaimer after 1958 of an interest created before 1977 will be recognized as free from federal gift tax only if it is made shortly after the initial transfer from which the interest sought to be disclaimed eventually emerged. Under this interpretation, future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. Such an approach is contrary to the view, widely held before the Supreme Court decided Jewett, that the 1958 regulation permits a tax-free disclaimer within a reasonable time after the death of the preceding life tenant, i.e. after the disclaimed interest becomes present and possessory. Moreover, as interpreted by the Supreme Court, the regulation represents a sharp departure from the law in effect prior to 1958 under which the effect of such a disclaimer was generally governed solely by state law. Thus, the Supreme Court's decision is very unfair to holders of interests created before 1958, who had no reason to disclaim before that time and never had an opportunity to disclaim without gift tax -- even "within a reasonable time" -- after the regulation was promulgated.

Law Before 1958

Prior to the 1958 regulation there were few cases involving the federal estate and gift tax effect of disclaimers. Nevertheless those few cases made clear that disclaimers which were valid and effective under state law did not result in a taxable gift.

In 1933, the Sixth Circuit decided Brown v. Routzahn, 63 F.2d 914, cert. den. 290 U.S. 641 (1933). In Brown decedent's wife died in 1912 and left decedent one-third of all her property. In April 1920, before any distribution was made, decedent filed with the proper probate court a renunciation of his right to the third of the estate, and the court, ordering distribution to the remaining heirs, recognized the renunciation. However, at decedent's death the Commissioner contended that the value of the renounced property should be included in decedent's estate for federal estate tax purposes as a transfer made in contemplation of death.

In analyzing the issue, the Court of Appeals began from the "obvious" premise that unless the decedent accepted the gift of one-third of his wife's estate or became owner of such interest before April 1920, there could be no transfer of such interest in contemplation of death within the meaning of the tax statute. Looking to state law and finding that under Ohio law a rejection of a gift by will made any time before distribution would be valid and that decedent therefore had never become owner of the property involved, the court concluded that his renunciation of the property could not be a taxable transfer for federal tax purposes.[2]

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[2] Although Brown involved the meaning of "transfer" for estate tax purposes, as we shall see, the term has been interpreted in the same manner under the gift tax. As the Supreme Court has stated, the federal estate and gift taxes are in pari materia and must be construed together. Estate of Sanford v. Commissioner, 308 U.S. 39, 44 (1939). Also see S. Rept. No. 1013, Part 2, 80th Cong., 2d Sess., 32, 1948-1 C.B. 285, 353.

There was no indication by the Internal Revenue Service of its intent not to follow the Brown decision. No other decision bearing significantly upon the issue arose until 1952, when the Eighth Circuit decided Hardenbergh v. Commissioner, 198 F.2d 63, cert. den. 344 U.S. 836 (1952). In Hardenbergh the taxpayers attempted to renounce their interest in the estate of a decedent who had died intestate, and the Internal Revenue Service claimed that the disclaimer constituted a taxable gift. The Eighth Circuit found that immediately upon the death of the decedent title to the disclaimants' interests had vested in them by operation of Minnesota law which neither disclaimant had the power to prevent, with the result that their subsequent disclaimers constituted transfers of such interests for federal gift tax purposes. Thus Hardenbergh reinforced the principle that validity of a disclaimer under state law controlled for federal estate and gift tax purposes. Indeed, Hardenbergh cited Brown with approval with respect to disclaimers of testamentary gifts, carefully distinguishing Brown on the basis of the testate-intestate state law difference. 198 F.2d at 66.

A number of commentators during this period recognized the principle that state law controlled in determining the tax effect of disclaimers. See, e.g., Ekman, "Can A Transferee Avoid Gift or Estate Tax Liability By Renouncing A 'Transfer By Operation of Law,'" 11 N.Y.U. Inst. on Fed. Tax'n 527, 532-534 (1953); Sayles, "Renunciations -- Estate and Gift Tax Problems," 1953 S. Cal. Tax Inst. 531, 536-539. There was some variance in state disclaimer statutes, and some states, in fact, had no disclaimer statute at all. Nevertheless, as a general rule a disclaimer of an interest was valid under state law if it was unequivocal, made without previous acceptance, and made within a reasonable time. 6 Bowe-Parker, Page on Wills § 49.9, 49.1, 49.8 (1962); 96 C.J.S. § 1151(b), 1151(a) (1957). In the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement. See 6 Bowe-Parker, Page on Wills § 49.8 (1962). Also see Estate of Page, 74 A.2d 614, 615-616 (N.J. Super. 1970).

A review of these cases and commentary reveals that prior to 1958 nothing in federal estate or gift tax law would require the holder of a remainder interest created by will to disclaim immediately upon the creation of the interest. Generally under state law the holder could wait until a reasonable time after the termination of the preceding interest, and the decided cases indicated that federal tax consequences of the disclaimer were controlled by state law. Against this historical background, section 25.2511-1(c), Gift Tax Regs. was issued in final form on November 15, 1958.

The 1958 Regulation

Section 25.2511-1(c), Gift Tax Regs., which has not been changed since it was promulgated in final form in 1958, provides in pertinent part as follows:

> "Where the law governing the administration of the decedent's estate gives a beneficiary, heir, or next-of-kin a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent (whether the transfer is effected by the decedent's will or by the law of descent and distribution of intestate property), a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. The refusal must be unequivocable [sic] and effective under the local law. There can be no refusal of ownership of property after its acceptance. Where the local law does not permit such a refusal, any disposition by the beneficiary, heir or next-of-kin whereby ownership is transferred gratuitously to another constitutes the making of a gift by the beneficiary, heir, or next-of-kin. In any case where a refusal is purported to relate to only a part of the property, the determination of whether or not there has been a complete and unqualified refusal to accept ownership will depend on all of the facts and circumstances in each particular case, taking into account the recognition and effectiveness of such a purported refusal under the local law. In the absence of facts to the contrary, if a person fails to refuse to accept a transfer to him of ownership of a decedent's property within a reasonable time after learning of the existence of the transfer, he will be presumed to have accepted the property. In illustration, if Blackacre was devised to A under the decedent's will

> (which also provided that all lapsed legacies and devises shall go to B, the residuary beneficiary), and under the local law A could refuse to accept ownership in which case title would be considered as never having pased to A, A's refusal to accept Blackacre within a reasonabe time of learning of the devise will not constitute the making of a gift by A to B. However, if a decedent who owned Greenacre died intestate with C and D as his only heirs, and under local law the heir of an intestate cannot by refusal to accept, prevent himself from becoming an owner of intestate property, any gratuitous disposition by C (by whatever term it is known) whereby he gives up his ownership of a portion of Greenacre and D acquires the whole thereof constitutes the making of a gift by C to D." Emphasis added.

This version of the regulation is somewhat different from a draft initially proposed on January 3, 1957, which required a renunciation to be made "within a reasonable time after knowledge of the existence of the interest" (emphasis added), rather than after knowledge of the existence of the "transfer," as provided in the final regulation. The word "interest" would clearly include a contingent remainder even if the creation of that remainder by will did not effect a "transfer" to the disclaimant. Thus, under the regulation as originally proposed, the holder of a future interest would only have had a reasonable time after the creation of the interest in which to disclaim and would not have been permitted to wait until the interest became present and possessory by transfer of the property to him.

On its face, this difference between the proposed and final regulations suggests that the final regulation was a rejection of the requirement of the proposed regulation that a disclaimer of a contingent interest be made within a reasonable time after its creation rather than a reasonable time after it became possessory. However, in its Jewett opinion the Supreme Court considered the change in language and concluded, based on a Memorandum from the Commissioner of Internal Revenue to the Secretary of the Treasury, dated October 1, 1958, that the reason for the change was unrelated to the issue of when a future interest must be disclaimed. With respect to the disclaimer regulation, the Memorandum provides in part as follows:

> "In what was intended to be the application of the rules in Brown v. Routzahn (1933) 63 F.2d 914, cert. denied 290 U.S. 641, and Hardenbergh v. Commissioner (1952) 198 F. 2d 63, cert. denied 344 U.S. 836, it was stated that where title to the property did not vest in the beneficiary or heir immediately upon the decedent's death, the renunciation of the property did not constitute the making of a gift, but that where title vested in the beneficiary or heir immediately upon the decedent's death, the act of the beneficiary or heir in giving up what passed to him from the decedent constituted the making of a gift.... Protests on these provisions were received. After reviewing these protests, we have reconsidered our position and now believe that the proper distinction between these two court cases turns on the question of whether under the applicable State law a beneficiary or heir can or

> cannot refuse to accept ownership of the property which passed from the decedent. Accordingly, we have revised paragraph (c) of section 25.2511-1 to reflect this change of position." XIII Tax Notes 203, July 27, 1981.

Two things are apparent: (1) Even if it is assumed that the drafters of the final regulation were not intentionally trying to state a different rule for contingent interests than set forth in the proposed regulation, this would not have been apparent to holders of contingent interests at the time, since the Memorandum was not made public until June 15, 1981. (2) The Memorandum clearly indicates that the drafters were trying to soften the inflexibility of the proposed rules and to provide, instead, that state law would apply in every situation. And, as previously noted, under the law applicable in most states, in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

It was not immediately apparent that the 1958 regulation was intended to make a change in the Treasury position as to when a valid disclaimer must occur. Although it specified three requirements not mentioned in Brown -- that a disclaimer be unequivocal, that it be made before acceptance of the interest, and that it be made within a reasonable time of knowledge of the existence of the transfer, the Eighth Circuit subsequently observed that the conditions in the regulation were "but a codification of common law principles applicable to the doctrine of disclaimers." Keinath v. Commissioner, 480 F.2d 57, 61 (1973).

What taxpayers and the tax bar did not then know was that the IRS would eventually introduce a new concept by contending that when it said a taxpayer must disclaim within a reasonable time after "the transfer," it meant in the case of a contingent interest, a reasonable time after creation of the interest rather than a reasonable time after the interest became possessory. It was in litigation of Keinath v. Commissioner in the Tax Court in 1972, that the Service first publicly took the position that the regulation required the holder of a future interest to disclaim shortly after the interest was created rather than after the termination of the preceding interest. See statement of counsel for the Commissioner of Internal Revenue in oral argument before the U.S. Supreme Court in Jewett v. Commissioner, No. 80-1614, 44-45 (December 1, 1981). This position of the Service was inconsistent with the Brown case, which the Memorandum indicates was intended to be embodied in the regulation, and contrary to the general principle of state law that disclaimers could be made after termination of the preceding life interest.

It now further appears that the position the IRS took in Keinath was also inconsistent with its own position in an earlier private letter ruling (6612201590A) dated December 20, 1966.[31] In that ruling the IRS held that a taxpayer's proposed disclaimer of a contingent interest in a trust created 33 years earlier would not be taxable as a gift. Under the terms of the trust, after the death of the taxpayer's mother and the termination of her life interest in trust income, the income of the trust was to be paid in equal shares to the mother's surviving children (including the taxpayer) and to the "issue per stirpes" of any child who survived the mother but died before termination of the trust. The taxpayer and her three siblings each received a one-fourth share of trust income after the death of their mother in 1936. Much later, in 1963 and 1964, the taxpayer became eligible for two additional one-eighth income interests because of the deaths of two siblings who were survived by adopted sons but not by "issue." The Service ruled that if a disclaimer was executed "within a 'reasonable time' from the time that she first receives notice [by reason of a court decision that the income interest had vested in her] of her right to the additional income interest," the requirements of the regulation would be satisfied and no gift tax would be due. Because the taxpayer already held another interest in the trust from which she had received income for nearly 30 years, she had obviously long been aware of the creation of the trust 33 years earlier and of her contingent interests in her siblings' shares in the event of survivorship. Thus, the above quoted language of the ruling means that she had a reasonable period from the time she received notice that her additional contingent income interest had vested or become possessory, even though that interest had been created 33 years earlier.

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[31] Although private rulings were confidential at that time, since 1976 they have been released to the public, and this particular ruling was made open to public inspection on August 28, 1978.

A careful review of the private rulings issued as far back as 1954 which have been released to the public reveals no ruling requiring disclaimer of a future interest before the preceding life tenant's death until the Service publicly took that position in Keinath. While the Service refused to rule in two cases involving present possessory interests on the timely disclaimer issue in 1973 on the ground that whether a disclaimer was made within a reasonable time was a factual issue to be decided by the district director (PR 7302140070A and PR 7307190100A), there appears to be no ruling embodying the IRS position in Keinath until 1978 (PR 7806080).

Although all of these private letter rulings were public when the Jewett case was briefed and argued before the Supreme Court, the Court was apparently not made aware of the inconsistent interpretations of the regulation made by the

IRS.[4] In fact, the Court expressly noted in upholding the Commissioner's interpretation of the regulation that the Service had been consistent in its interpretations over the years -- which is simply not so. 102 S.Ct. 1090.

Conclusion

This examination of the federal gift tax law on disclaimers before and after 1958 demonstrates that under the Brown and Heidenhergh cases the validity of the disclaimer under state law determined the federal gift tax result. Thus, before 1958 the holder of a contingent remainder had no reason to disclaim prior to the death of the preceding life tenant.

After the promulgation of the 1958 regulation it was not apparent that there had been any change in the law. First of all, the deletion of language from the proposed regulation which required disclaimer "within a reasonable time after knowledge of the existence of the interest" sugguested that a disclaimer could be delayed until indefeasible vesting.

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[4] Even though section 6110(j)(3) of the Code provides that private rulings ordinarily "may not be used or cited as precedent," the Supreme Court -- in refusing to accept the government's interpretation of a long-standing regulation in Rowan Companies, Inc. v. U.S., 101 S. Ct. 2288, 2296, n. 17 (1981) --has said that private rulings may be cited as evidence that the Internal Revenue Service has taken a position inconsistent with its present contentions as to the meaning of the law and regulations.

Furthermore, the October 1, 1958, Memorandum from the Commissioner to the Secretary of the Treasury shows that the drafters of the regulation were trying to follow the existing law of the Brown and Heidenbergh cases. In addition, the IRS itself, in Private Ruling 6612201590A, issued December 20, 1966, ruled that a disclaimer of a contingent future interest would satisfy the regulation if made after notice that the interest had vested and become possessory. Indeed, it was not until litigation of the Keinath case in the Tax Court in 1972, after disclaimers of taxpayers such as Helen Wodell Halbach, who disclaimed in 1970, that the IRS first publicly took the position that a defeasible future interest must be disclaimed shortly after its creation.

In spite of these indications of the meaning of the regulation, the Supreme Court in Jewett adopted the Commissioner's current contrary interpretation. Thus, under the Supreme Court's interpretation, the IRS, by promulgating the 1958 regulation, changed the rules for a taxpayer owning an interest created before 1958 in the middle of the game, contrary to any reasonable notion of justice or fair play.

In rejecting a similar unfairness argument by the taxpayer in Jewett, the Court noted that the 1958 regulation was made well in advance of the disclaimers in that case.[5] However, what is important here is that the interest was created before 1958, not that it was disclaimed after 1958, since under the Court's interpretation of the regulation holders of pre-1958 interests were unfairly and unjustifiably prevented from ever disclaiming following promulgation of the regulation without incurring a gift tax. At that point, according to Jewett, it was already too late. Congress recognized this very distinction when it made section 2518 applicable only to disclaimers of interests created after 1976; that section is currently inapplicable to disclaimers made after 1976 of interests created before 1977. See Section 2009(e) of the Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520.

H.R. 2583 and S. 1983 would correct the unfair effect of Jewett on holders of pre-1958 future interests by providing a grace period for disclaimer of such interests. As the discussion above shows, the equities weigh heavily in favor of such relief.

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[5] The Court also makes the puzzling comment that the taxpayer's argument would have more appeal if the disclaimer had been made immediately after the adoption of the 1958 regulation, rather than 14 years later. 102 S.Ct. 1090, n. 20. The logic of this statement is difficult to understand if, in fact, the regulation required disclaimer in 1939 when the disclaimer interest was created. Furthermore, the taxpayer's argument seems to have great appeal where the IRS itself had interpreted the regulation as favorable to the taxpayer's position and never publicly took the contrary view until after the disclaimer occurred.

Legislative History

H.R. 7601, the predecessor of H.R. 2583 and S. 1983, was introduced by eight sponsors--Reps. Guarini (D., N.J.), Moorhead (D., Pa.), Wolff (D., N.Y.), Lundine (D., N.Y.), Conable (R., N.Y.), Rinaldo (R., N.J.), Green (R., N.Y.), and Lee (R., N.Y.) -- in the Second Session of the 96th Congress on June 17, 1980. The bill was limited to disclaimers of interests created before 1958, rather than before 1977, because the sponsors felt that the equities were strongest for holders of pre-1958 interests. The bill was referred to the Committee on Ways and Means and Select Revenue Measures Subcommittee, where it was due to be the subject of a hearing when time ran out at the end of the Session.

H.R. 2583 was introduced by Rep. Conable, for himself, Rep. Green and Rep. Ludine, on March 18, 1981, in the First Session of the 97th Congress.

S. 1983 was introduced on November 30, 1981, by Sen. Symms (R., Id.) for himself and Sen. Wallop (R., Wyo.). Testimony on the issue had previously been heard May 1, 1981, by the Subcommittee on Estate and Gift Taxation of the Senate Finance Committee.

PREPARED STATEMENT OF JAMES C. HEINHOLD, WASHINGTON, D.C.

Good afternoon Senators. My name is Jim Heinhold, and I am with the law firm of Shea & Gould in Washington. With me is the Honorable Wilbur D. Mills, also of our firm.

First, I would like to thank you, Senator Symms, and the members of your subcommittee for inviting me to testify on S. 1983.

Generally speaking, a disclaimer is a renunciation or a refusal to accept a gift or an inheritance. If a disclaimer is properly made and is deemed effective for gift tax purposes, the person making the disclaimer is not considered to have made a gift to the person who eventually takes the property. If the disclaimer is not treated as valid for federal gift tax purposes, the person making the disclaimer will be deemed to have made a taxable gift. For instance, a husband may pass property to his wife for her to use during her life, and then to their daughter and then to their grandchildren. It may happen that by the time the mother dies and the daughter has a right to take possession of the property, that her own circumstances are such that she does not wish to have the property and so she refuses to accept it. She disclaims any right to it and the property will pass to the grandchildren if there are any. The question is when must the daughter disclaim in order for it to be considered a valid disclaimer and not a gift?

Prior to 1976, there was no federal law on whether a disclaimer was subject to a gift tax. The gift tax consequences of a disclaimer were largely dependent upon its effectiveness under local law. The underlying principle of all local law was that if a person absolutely refused to accept the property, then he would not be considered to have received it and thus could not give it away. You can't give what you don't have.

Even though there was no federal law governing these disclaimers, the I.R.S., in 1958, decided to establish some standards for the making of a valid disclaimer. One standard was that a disclaimer had to be made within a "reasonable time after knowldge of the existence of the transfer." This requirement did not immediately cause any alarm because making a disclaimer within a "reasonable time after the transfer" was not a new concept. However, what the tax bar did not know was that the I.R.S. was about to introduce a new concept by interpreting the word "transfer" to mean that point in time when the trust was created. Now for many years, tax practitioners uniformly have been of the view and local law agreed, that the proper time to disclaim was when the life beneficiary had died and the next beneficiary was entitled to possession of the interest, rather than when the trust was created. This contrary position by the I.R.S. caused mass confusion and led to a number of contradictory court decisions.

In 1976, Section 2518 was added to the Internal Revenue Code and essentially adopted the I.R.S. position but only for disclaimers of property interests created after 1976. This section specifically stated that it was not to change prior law. Nevertheless, the I.R.S. has persisted in applying the standards of Section 2518 retroactively.

Ironically, the 1976 Act gives the holders of remainder interests created after 1976 a nine-month period in which to disclaim, yet the IRS maintains those interests created before the law was enacted are to be denied any time within which to conform to the new standards. This could not have been the intent of Congress.

The inequity of the IRS position is greatest with regard to those interests created prior to the publication of the IRS regulations in 1958. Prior to that date, the law was clear that a disclaimer did not constitute a taxable gift so long as it was effective under applicable local law. Because local law generally did not require that a disclaimer be made until after the interest became possessory, many interests created in 1920 or 1940 or even 1950 and not reduced to possession by the time of the IRS regulations, never had the opportunity to disclaim subsequent to the announcement of the new policy.

The Supreme Court earlier this year [1] settled the question of when a transfer, referred to in the IRS regulation, takes place. Their decision was that the transfer occurs when the interest is created—rather than when the interest passes to the disclaimant. From that decision it follows that the IRS rule of "timeliness" means that a disclaimer must be made soon after the trust was created—regardless of the likelihood that a contingent interest will ever become possessory.

The Supreme Court decision does not deal with the question of the IRS changing the rules without the benefit of a Congressional mandate. Nor does the decision deal with the basic injustice that results from retroactively applying new rules. Finally, the decision does not deal with the irony and inequity that exists under present law that permits trusts created after 1976 to have nine months within which to disclaim an interest but to never have given the opportunity to conform to trusts created 20 years before the new rules were written.

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[1] *Jewett* v. *Commissioner,* 202 S. CT. 1082 (1982).

What we are suggesting, is an amendment to S. 2518 after Internal Revenue code which would permit those interests created before 1958 to have a period of nine months after the enactment of the bill within which to disclaim their interests and be treated as a qualified disclaimer under Section 2518. In other words, the same treatment as those who created trusts after 1976 with full knowledge of the new law.

Senator SYMMS. I am expecting another vote on the floor, so we will move right along. I appreciate both of your excellent statements.

All of the complete statements of those who have testified here this afternoon will be made part of the record.

Now we want to hear from H. Stewart Dunn on the valuation of mineral properties for estate taxes.

STATEMENT OF H. STEWART DUNN, JR., IVINS, PHILLIPS & BARKER, WASHINGTON, D.C.

Mr. DUNN. Mr. Chairman, I am Stewart Dunn, a member of the Washington law firm of Ivins, Phillips & Barker. I appear here as one who has spent 25 years in the field of estate tax valuation and who has testified before this committee—the Senate Finance Committee—on other occasions on estate tax matters.

At this time, when we have been made aware by the Reagan administration, the prior administration, and many others, of the critical and alarming dependency of our country on the import of nonfuel materials, I wish to strongly support the bill you have proposed.

This bill will provide encouragement and add financial incentive for entrepreneurs to invest their capital in location and exploration of minerals upon which our country and our security are vitally dependent.

Of the 36 strategic materials, mainly metals, which are essential to our economy and our production of military hardware, the United States today is dependent upon unstable or hostile nations for 22. Some of these come principally from areas under the control or influence of the Soviet Union. Also, we are heavily dependent on the region of Southern Africa for 76 percent of our cobalt, 93 percent of our platinum, 48 percent of our chromium, and a host of other strategic and critical materials. Without these materials we cannot build jet aircraft, weapons, and other military hardware vitally important to the national security.

Fortunately, the seriousness of this problem is recognized both by the current administration and by others. Most recently, President Reagan, as you noted, outlined U.S. mineral vulnerability in his National Materials and Minerals Report submitted to the Congress in April of this year. The dominant theme of the President's Report was that the problem of declining American mineral production has many causes, and that the problem would therefore not be solved without the application of a number of different remedies.

Most of these remedies, such as price supports and protection of foreign sources, will involve at the minimum the expenditure of hundreds of millions of dollars.

Because the current budget crisis will prevent or delay enactment of the most costly alternatives, Congress should immediately take those steps which do not have significant revenue implications.

The legislation that you have proposed falls within that category. Your bill does nothing more but defer imposition of any estate tax or any other transfer tax on undeveloped mineral property until the property is actually productive or disposed of. Any such deferrals would not result in any measurable loss of revenue to the Government.

Deposits of hard minerals are particularly difficult to locate. Once a hard mineral deposit is located, defining the extent of the deposit to determine whether it is worth extracting is extremely expensive and very time consuming. According to the American Mining Congress, the development of a mineral deposit takes between 8 and 35 years.

The very large amount of capital needed to locate and explore a mineral property and the extended time for development have deterred individuals from participating in this sector of the economy by virtue of the risk of being taxed before there is any hope of recovering revenue from the production of minerals in commercial quantities. While there are individual entrepreneurs who have been willing to invest their resources in this strategically important sector of the economy despite these risks, many others will be encouraged to do so if the tax burden can be deferred until the mineral property becomes commercially productive.

As in other sectors of the American economy, participation of the individual entrepreneur is a necessary forerunner to the effort of a large corporation. For one thing, the individual entrepreneur can explore and develop opportunities that corporations accountable to public shareholders would eschew for being too risky or for exposing them to public scrutiny and criticism in the event of failure.

Consider, however, what an individual faces when he chooses to involve himself in mineral exploration and development. Should he be fortunate enough to locate or acquire a property with some prospect for profitable production, he must commit himself to a huge outlay of capital for geological surveys, drilling equipment, labor, and construction of the mine. Because it will take 8 to 35 years for his efforts to bear fruit, the possibility that he will not be alive when the mine begins production is a significant consideration. If the entrepreneur dies before the property is fully developed, imposition of a premature estate tax on the property could deprive the enterprise of the liquid capital needed to complete development.

In addition, because the value of underdeveloped mineral property is always speculative, the individual bears the risk that the Internal Revenue Service could apply an unrealistically high value which, because of its very speculative nature, would be difficult to disprove. Keep in mind that the burden of proof on these matters rests with the taxpayer. A review of the case law shows that in the past the difference between the taxpayer's valuation of the undeveloped mineral property and the Internal Revenue Service's valuation has sometimes differed by a factor of as much as 10 to 1. In such cases the courts will often split the difference, which results in a valuation many times higher than the taxpayer had calculated.

Under the bill you propose the Service would continue to value undeveloped mineral property at the time of transfer in accordance with its prevailing procedures. However, imposition of the transfer tax would be postponed until the property becomes productive or is sold, whichever is earlier.

Under this bill the tax is deferred, not eliminated. To insure eventual payment of the tax, the provisions of this bill will not apply unless all those who inherit the mineral interest agree to assume personal liability for the payment of the tax. The heirs can avoid personal liability only by providing a bond satisfactory to the Treasury. In addition, a lien on the property for the amount of the tax is created in favor of the United States.

I wish to thank you, as chairman of the subcommittee, for the opportunity to speak in favor of this legislation, which with little or no revenue loss to the Government will guarantee individuals that their investment in mineral property will not be frustrated by untimely imposition of a transfer tax.

As President Reagan stated in his April 1982 report, "New mineral deposits will not be found unless the private sector looks for them. It is to the Nation's advantage to encourage this search."

Thank you, Senator.

[The prepared statement follows:]

PREPARED STATEMENT OF H. STEWART DUNN, JR., MEMBER OF IVINS, PHILLIPS & BARKER, CHARTERED

Mr. Chairman, I am H. Stewart Dunn, Jr., a member of the Washington, D.C. law firm of Ivins, Phillips & Barker, Chartered. I appear here as one who has spent many years in the field of estate tax valuation and who has testified before the Finance Committee on other occasions on estate tax matters.

At this time, when we have been made aware by the Reagan Administration, the prior administration, and the news media of the critical and alarming dependency of our country on imports of non-fuel minerals, I wish to voice my comments in favor of S. ——. This bill will provide encouragement and add financial incentive for entrepreneurs to invest their capital in location and exploration of the minerals upon which our economy and security are vitally dependent.

In this regard, Mr. Chairman, let me say that for centuries, minerals have been basic to civilization; they have been essential to food, shelter, energy, industry, and defense. Without iron, aluminum, lead, zinc, copper, and many other minerals we mine in this country, the industrial society as we know it could not exist. In short, our engine of democracy would come to a halt.

Of the 36 so-called strategic materials, mainly metals, which are essential to our economy and our production of military hardware, the United States today is dependent on unstable or hostile nations for 22. For example, together with the United States, South Africa and the Soviet Union are the biggest mineral producers in the world.

To make the point, let me say that there are 200 million people in the United States who annually consume 41,000 pounds of minerals per person. That means over 4 billion tons of minerals are needed each year to sustain the nation's economy. A decline in domestic mineral production creates an increased dependence on foreign sources.

To aggravate this infringement on our economic stability, the U.S. has placed its national security in the hands of a few foreign nations. As I have indicated, we are heavily dependent on the region of Southern Africa for 76 percent of our cobalt, 93 percent of our platinum, 48 percent of our chromium, and a host of other strategic and critical materials. Without these materials, we cannot build jet aircraft, weapons, or other military hardware vitally important to our national security.

Fortunately, the seriousness of this problem has been recognized both by the current Administration and by its Democratic predecessor. Most recently, the President outlined U.S. mineral vulnerability in his National Materials and Minerals Report, submitted to the Congress in April of this year. The dominant theme of the President's Report was that the problem of declining American mineral production had many causes, and that the problem would therefore not be solved without the application of a number of different remedies.

In many cases, the potential for U.S. mineral production is great, but production is not profitable given current world prices. In such cases, we face a difficult choice. We may secure the less expensive foreign supplies by pursuing expensive and hazardous military options. Alternatively, we may encourage domestic production by guaranteeing domestic producers a price in excess of current world market prices. Both of these approaches will involve, at a minimum, the expenditure of hundreds of millions of dollars.

Another approach being pursued by the Administration is the elimination of rules and regulations which tend to impede mineral exploration and development. Unlike the other solutions being considered, the removal of administrative obstacles to mineral exploration, development, and production usually costs little or nothing in dollar terms to the Federal government. Because the current budget crisis will prevent or delay enactment of the more costly alternatives, Congress should immediately take those steps which do not have significant revenue implications.

The legislation before us today falls within that category. The bill does nothing more than defer imposition of any estate tax or any other transfer taxes on undeveloped mineral property until the property is actually productive or disposed of. Any such deferrals would not result in any measurable loss of revenue to the government.

Deposits of metallic or so-called "hard" minerals are particularly difficult to locate. Once a hard mineral deposit is located, defining the extent of the deposit to determine whether it is worth extracting is extremely expensive and very time consuming. According to the American Mining Congress, the development of a mineral deposit takes between 8 and 34½ years.

The very large amount of capital needed to locate and explore a mineral property and the extended time for develoment have deterred individuals from participating in this sector of the economy by virtue of the risk of being taxed before there is any hope of recovering revenue from the production of minerals in commercial quantities. While there are individual entrepreneurs who have been willing to invest their resources in this strategically important sector of the economy despite these risks, many others will be encouraged to do so if the tax burden can be deferred until the mineral property becomes commercially productive.

As in every other sector of the American economy, participation of the individual entrepreneur is a necessary forerunner to the efforts of large corporations. For one thing, the individual entrepreneur can explore and develop opportunities that corporations accountable to public shareholders would eschew for being too risky or for exposing them to public scrutiny and criticism in the even of failure.

Consider, however, what an individual faces when he chooses to involve himself in mineral exploration and development. Should he be fortunate enough to locate or acquire a property with some prospect for profitable production, he must commit himself to a huge outlay of capital for geological surveys, drilling equipment, labor, and construction of the mine. Because it will take from 8 to 35 years for his efforts to bear fruit, the possibility that he will not be alive when the mine begins production is a significant consideration. If the entrepreneur dies before the property is fully developed, imposition of a premature estate tax on the property could deprive the enterprise of the liquid capital needed to complete development.

In addition, because the value of undeveloped mineral property is always speculative, the individual bears the risk that the Service could apply an unrealistically high value which, because of its very speculative nature, would be difficult to disprove. Keep in mind that the burden of proof in these matters rests with the taxpayer. A review of the case law shows that in the past the differences between the taxpayer's valuation of undeveloped mineral property and the Internal Revenue Service's valuation has sometimes differed by a factor of as much as 10 to 1. In such cases, the courts will often "split the difference", which results in a valuation many times higher than the taxpayer had calculated.

Under the bill before you, the Service would continue to value undeveloped mineral property at the time of transfer in accordance with its prevailing procedures. However, imposition of the transfer tax would be postponed until the property became productive or was sold, whichever was earlier.

Whether or not the property became productive, the result would be superior to application of the tax at the time of transfer. First, if the heirs then disposed of the property outside of the family for a price less than the value assigned to the mineral interest by the IRS at the time of transfer, the tax would be based on the sales price. Clearly, under those circumstances, the sales price would more accurately reflect the fair market value of the property than would the IRS valuation, which was made when the property was in an earlier stage of exploration. Second, if there were no such disposition, the tax would be postponed until the property was generating income from which to pay the tax. As I noted earlier, if a substantial estate tax were imposed before development was completed, the heirs of the entrepreneur might be forced to liquidate the enterprise and cease development to generate funds to pay the tax.

Under this bill the tax is deferred, not eliminated. To insure eventual payment of the tax, the provisions of this bill will not apply unless all those who inherit the mineral interest agree to assume personal liability for payment of the tax. The heirs can avoid personal liability only by providing a satisfactory bond to the Treasury. In addition, a lien on the property for the amount of the tax is created in favor of the United States.

Because of the need for large amounts of capital to develop mineral property, and because of a desire to share the enormous risks in mineral development, individual entrepreneurs will often join together in partnerships or closely held corporations. The bill therefore applies not only to mineral interests directly held by an individual, but also to mineral interests held by him as a partner or shareholder.

I would like to thank the members of this Subcommittee for the opportunity to speak in favor of this legislation, which, with little or no revenue loss to the government, will guarantee individuals that their investments in mineral properties will not be frustrated by untimely imposition of transfer taxes. As President Reagan stated in his April, 1982 Report, "[n]ew mineral deposits will not be found unless the private sector looks for them. It is to the nation's advantage to encourage this search."

Thank you.

Senator SYMMS. Thank you very much for very excellent testimony in this matter that I have been interested in for many years, particularly during my time in the other body, on the House Interior Committee on the Mines and Mining Subcommittee. I think you make very excellent testimony, and we are very anxious to get the legislation submitted so we can start including it in an overall national minerals policy—a policy that this country should have, but one that we want to be self-dependent on these critical minerals.

I think you did an excellent service to this committee with this statement. So, thank you very much.

Mr. DUNN. Senator, I can tell you that there are a number of persons who would be much more inclined to invest if this bill can become part of the law.

Thank you very much.

Senator SYMMS. I thank you very much. We will keep the committee hearing record open for 2 weeks to accept any other testimony that may come forward.

The committee stands in adjournment.

[Whereupon, at 4:16 p.m., the hearing was concluded.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

FRANKFORT, IND., *May 28, 1982.*

ESTATE AND GIFT TAX SUBCOMMITTEE,
Senate Finance Committee,
Dirksen Senate Office Building, Washington, D.C.

GENTLEMEN: I just received notice in my morning mail that a hearing was being held yesterday on proposed changes in the Federal Estate tax law having to do with closely held businesses as qualifying for installment payment of estate taxes. I am sorry I didn't get this letter in to you before the hearing.

First of all, decisions by the IRS in this regard should be appealable to the tax court. With no appeal the decision of the IRS can be, and often is, arbitrary and capricious.

Second, by their regulations IRS permits installment payment only in case of an "active" business. This is not part of the statute. The statute merely speaks of a "business". The purpose of the installment payment provision is to prevent businesses having to be sold to pay taxes instead of passing them on to the new owners who will carry them on. This is just as much a problem with an active business as an inactive business. There is no reason to make a distinction. The IRS gets their money in both cases. This is especially critical in the case of a family farm which happens to be rented because the decedent is elderly and unable to farm it. The revision should make clear that it covers all businesses, not just those that meet the definition of the IRS for an "active" business.

Very truly yours,

ROBERT BRACKEN,
Attorney-at-Law.

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America (AGC) represents more than 30,000 firms including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities. We appreciate this opportunity to submit written testimony regarding the important issue of revisions to the installment payment rules for estates taxes.

The Economic Recovery Tax Act of 1981 made a number of significant and beneficial changes in the availability and operation of Section 6166 which allows for the installment payment of estate taxes following the death of a controlling principal. Notwithstanding, qualification and administrative rules governing the installment payment of estate taxes continues to be an uncertain and unnecessarily awkward procedure. We strongly support the provisions of S. 2479 which will ease the transfer of family operated firms following the death of a controlling principal.

The construction industry is made up of thousands of small firms run by family members. The ability to pay estate taxes in installments is critical to the continued operation of these firms as family businesses. The only options available to many of these firms if estate taxes cannot be paid in installments is liquidation or sale to another firm which is usually significantly larger.

The following provisions of the S. 2479 are of particular importance to the construction industry.

A. NECESSITY FOR JUDICIAL REVIEW

An overriding problem in this entire area is the fact that any dispute which arises under 6166 cannot be resolved in court, thereby making the IRS the sole arbiter of all controversies. This imbalance between the taxpayer and the Service needs to be remedied at the earliest possible time through the creation of a judicial forum for the resolution of all disputes arising under 6166. The declaratory judgment provision contained in the House-passed version of the Economic Recovery Tax Act of 1981 can serve as a model for legislation. However, decisions of the Tax Court should be reviewable by the circuit courts, as is the case with all other decisions issued by the Tax Court.

B. CLARIFICATION OF STATUS OF CORPORATE AND PARTNERSHIP HOLDING COMPANIES

In order to reflect present business practices which oftentimes utilize complex corporate and partnership holding company structures, 6166 should be clarified to permit a decedent to own a direct or indirect interest in a corporation or partnership carrying on a trade or business. There is no justifiable reason for the Internal Revenue Code to exclude partnership and corporate holding companies from the benefits of 6166. The Congressional purpose underlying 6166 (to provide a long-term payout to estates with liquidity problems in order to prevent a forced sale to larger publicly-owned companies) is equally relevant in the case of holding companies and entities without corporate or partnership subsidiaries.

C. CLOSELY HELD BUSINESS INTEREST SHOULD INCLUDE INDEBTEDNESS

Section 6166 should be amended to permit indebtedness to qualify for deferral benefits if the decedent's equity interest in the partnership or corporation, standing alone, would constitute a closely held business interest for purposes of 6166. Section 6166 should not contain a bias in favor of equity over indebtedness.

D. ELIMINATION OF DISTINCTION BETWEEN CAPITAL AND PROFITS INTEREST IN A PARTNERSHIP

Under present law, if a partnership has more than 15 partners (determined by taking into account the three attribution rules), the decedent must own 20 percent or more of the total capital interest in such partnership in order to qualify for 6166. There are several reasons to amend 6166(b)(1)(B)(i) to eliminate the distinction between an interest in partnership capital and an interest in partnership profits. First, if the partnership has 15 or fewer partners, the decedent's partnership interest can qualify even if such interest is limited to partnership profits. Second, for purposes of the aggregation rule in 6166(c), the decedent must own 20 percent or more of the total value of each business without regard to whether the decedent's partnership interest relates to capital or profits. Finally, numerous sections of the Internal Revenue Code provide for attribution between a partner and a partnership where the partner owns a prescribed interest in either partnership profits or partnership capital.

E. ELIMINATION OF DISTINCTION BETWEEN VOTING AND NONVOTING STOCK

Under present law, if a corporation has more than 15 shareholders (determined by applying the three attribution rules), the decedent must own 20 percent or more in value of the voting stock of such corporation in order to qualify for 6166. There are several reasons 6166(b)(1)(c)(i) should be amended to eliminate the distinction between voting and nonvoting stock. First, if the corporation has 15 or fewer shareholders, the decedent's stock interest can qualify even if such interest is comprised solely of nonvoting stock. Second, for purposes of the aggregation rule in 6166(c), the decedent must own 20 percent or more of the total value of each business without regard to whether the decedent's stock is voting or nonvoting. Finally, several provisions of the Internal Revenue Code provide for attribution between a shareholder and a corporation where the shareholder owns a certain minimum percentage of the value of the outstanding stock (including both voting and nonvoting stock).

F. INTEREST AS AN ADMINISTRATION EXPENSE

An extremely complicated situation is presented because interest throughout the 15-year period is deductible as an administration expense under Code Section 2053, but a deduction can be claimed only when the interest is actually paid or accrued. Interest attributable to the section 6166 deferral period should continue to be deductible as an administration expense. However, the interest rate should be fixed for the entire deferral period, geared to the then prevailing yield on Treasury obligations of comparable maturity. All of the interest attributable to the payout period, including interest imposed by a state, should be deductible when the estate tax return is filed. Adjusted gross estate threshold requirement and the limitation on the amount of estate taxes deferrable under 6166 could be revised to take into account the fact that the adjusted gross estate will increase as a result of the proposed changes.

G. COORDINATION WITH SUBCHAPTER S PROVISIONS

In order to preserve the historic relationship between the Subchapter S provisions and the estate tax deferral provisions, a decedent's interest in a corporation should qualify under 6166 if such entity has 25 or fewer stockholders. In order to achieve additional coordination between the two provisions, the spousal attribution rules (in 6166(b)(2)(B) and 6166(c)) should be revised to eliminate the common ownership requirement and to include estates of deceased spouses.

H. SIMPLIFICATION OF ATTRIBUTION RULES

Under present law, in determining whether the 15-person numerical test is satisfied, three entity attribution rules are applicable: spousal, family and entity. In determining whether the percentage ownership test is satisfied, the executor can elect to apply these three attribution rules by giving up the 4 percent interest rate and the 5-year interest only provisions. Moveover, the attribution rules do not operate in the same fashion, since spousal and entity attribution are not limited to the decedent, whereas family attribution applies only between the decedent and members of his family. In addition, in the case of a husband and wife where one of the spouses is the decedent, both spousal and family attribution should be applicable, although spousal attribution is limited to situations in which the closely held business interest is jointly or commonly owned.

Present law should be amended to combine the spousal and family attribution rules into a single provision applicable, without any penalities, to both the percentage and numerical qualification tests.

I. EXPANSION OF AGGREGATION RULE TO INCLUDE NUMERICAL TEST

Aggregation under 6166(c) should be permitted for each of the decedent's interests which satisfy either the numerical or percentage qualification tests. Since modern business practices often favor the creation of multiple entities, 6166 should not impose a stiffer requirement in the case of two more entities, and provide a more lenient qualification standard where the decedent dies owning a single closely held business interest.

J. EXPANSION OF ACCELERATION EXCEPTIONS

Since buy-out agreements are often an essential element in the continuation of a closely held business after the death of one of the owners, 6166 should be amended to permit an estate to sell its stock or partnership interest in exchange for a note without resulting in acceration. The American Bar Association has recommended this specific change.

In addition, in order to enable buy-out to occur prior to the death of one of the owners, 6166 should be amended to permit a note receivable from a corporation or partnership to be eligible for the deferral privileges if the decedent had died owning such interest and such interest would have qualified under 6166.

The acceleration exception for 303 redemptions should be expanded to permit the proceeds of such redemption to be used for any of the purposes enumerated in 303(a). Under current law, a 303 redemption can include amounts sufficient to cover federal and state death taxes, interest on such death taxes, and funeral and administration expenses under 2053, whereas 6166(g)(1)(B) is limited to federal estate taxes.

In addition, the acceleration exception should be expanded to provide equivalent treatment for partnerships. There is no justification for permitting an estate to receive funds from a closely held corporation to pay enumerated expenses without causing acceleration, but to deny that privilege to partnerships. Acceleration is not justified in either case because the estate must pay such expenses with the funds it receives from the entity.

The acceleration exception in 6166(g)(1)(C) should be expanded to include all reorganizations under 368 if the stock received by the decedent's estate (or heirs) would have qualified as a closely held business interest if owned by the decedent on the date of his death or constitutes non-readily-tradable stock within the meaning of 6166(b)(7)(B). In effect, closely held businesses should be allowed to be acquired by unrelated closely held businesses without causing acceleration.

Finally, the acceleration exception for subsequent death-related transfers should be amended to repeal the family limitation. When the original decedent dies, 6166 is available whether or not the decedent leaves any portion of the estate to non-family members. However, on the death of an heir of the original decedent, the acceleration exception is available only if the subsequent transferee is a member of the transferor's family. There are many situations in which business associates (including employees) and charitable organizations are beneficiaries of an estate. In effect, under present law, an heir of the original decedent is penalized if the closely held business interest is left, in whole or in part, to such business colleagues or charitable organizations.

K. LEASED ASSETS

Section 6166 should apply to the assets used by the closely held business whether such assets are directly owned by that business or leased to the business by a partner or stockholder. Accordingly, corrective legislation should provide that assets directly or indirectly owned by the decedent that are leased to a closely held business should qualify for purposes of section 6166 if such assets are used by the closely held business in carrying on a trade or business, throughout the 1-year period ending on the date of the decedent's death, and the decedent's stock or partnership interest in such closely held business qualifies for purposes of section 6166.

By contrast, where money or other property is contributed or loaned to a closely held business but is not used in carrying on the trade or business during the 1-year period prior to death, section 6166 should not be available with respect to such money or other property.

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